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Climate Change Authority's Caps and Targets Review

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Climate Change Authority's (CCA) Caps and Targets Review Issues Paper.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 36 electricity and downstream natural gas businesses. These businesses own and operate some $120 billion in assets, employ more than 51,000 people and contribute $16.5 billion directly to the nation's Gross Domestic Product.

The esaa has been continually engaged in the development of a carbon pricing scheme in Australia over the past few years. The CCA's Caps and Targets Review is the next stage in this process and one that will play an important role in developing a carbon market in Australia.

A return to emissions 'gateways'

Throughout the development of a carbon pricing mechanism, the esaa has consistently argued for a stronger signal on future scheme caps. While the Clean Energy Act only provides for rolling 5-year scheme caps rather than the Association's preferred 10-year rolling scheme cap, there is an opportunity for a longer term guide to be set through emissions trajectories which the CCA is also investigating.

Trajectories can provide a stronger indication of future emissions pathways and may form an important role in informing future investment decisions in the energy supply sector. The esaa notes that there are many factors that could influence future emissions targets and Australia's capability to reach these targets. As such, we consider that the CCA should set out these trajectories on the form of a gateway indicating a possible range of emissions levels out to 2025 or 2030. The Association called for the use of gateways in our submission on the Clean Energy Future legislation, and continues to consider them a useful way to provide an investment signal to industry.

Strategic milestones

The Authority raises the question of setting strategic milestones for different sectors. These milestones will be used to evaluate Australia's progress towards long-term

emissions reduction goals. The esaa understands that these milestones may provide useful guidance to the Authority. Particular issues relating to the electricity sector are outlined below. More generally, there is a logical distinction to be drawn between sectors covered by the cap and those not covered.

Uncovered sectors face regulatory impositions which may reduce or have already reduced emissions. In the near-term the Authority's expectations of the uncovered emissions (which will consequently have implications for the level of the cap) will need to be based on current policy settings. In the longer term, should the expected trajectory of uncovered emissions differ markedly from the overall emissions trajectory, then it is reasonable to suppose that additional action should and will be taken to curb emissions in those sectors. In this context, setting strategic milestones provides a useful guide to where the focus of additional policies should be.

The Association recognises the difficulties the CCA will face in setting strategic milestones. Given the logic of the carbon price mechanism is to elicit least cost abatement, then, if feasible, a reasonable approach would be that each uncovered sector should face an emissions trajectory where the marginal cost of abatement is equal to the expected carbon price that will apply to the covered sector. Even then, the milestones that result will depend on a range of assumptions that could change quite quickly. If it is not possible to estimate trajectories in this way, then the CCA will have to make a broader judgment.

Within the covered sectors the rationale for strategic milestones is less clear. There is a strong risk that setting milestones creates an expectation that each sector "should" reach its milestone and that if it appears unlikely, additional, non-complementary policies are imposed on the sector. These will undermine the efficiency of the carbon pricing mechanism, an important merit of which is that governments do not have to prejudge where the most efficient abatement will come from.

In this context it is of particular concern that the CCA is signalling that the only sector that may be subject to milestones at this review is the electricity sector.

Setting milestones for the electricity sector

The process of setting milestones, especially over a long time frame, is fraught with great uncertainty. For the electricity sector, emissions can be considered as being a combination of the level of demand and the emission intensity of the supply side. Changes to either of these will affect overall emissions.

Demand projections over the past few years have proven unreliable and have been revised. The industry is still coming to grips with the shift away from a pattern of consistent demand growth in line with general economic growth. This has introduced a new level of uncertainty over future demand.

On the one hand, the past few years have seen demand flatline after years of solid growth. The lack of growth is due to a number of reasons; primarily it is the result of a weak economy and shutdowns in manufacturing and heavy industry, such as aluminium smelters. As illustrated by last year's closure of the Kurri Kurri smelter in NSW and the recent announcement that Ford factories in Victoria will close in 2016, there is a risk of significant deindustrialisation. This will merely shift the emissions

associated with those processing and manufacturing activities offshore, where they may or may not be more emissions intensive.

On the other hand, there is the potential for emissions to move under the cap from the uncovered transport sector if electric vehicles begin to be adopted widely. Electric vehicles are currently a niche product but broad uptake would transfer a proportion of emissions from transport to electricity generation. Such a change would require the cap to be adjusted to reflect the transfer of emissions rather than a supposed reduction from one sector and increase from another.

On the supply side a major uncertainty is the future price path of gas. Gas markets in all parts of Australia are being affected by the development of export facilities and the consequent trend towards international prices. International prices themselves are subject to great uncertainty, with the impact of potential exports from North America into the Asia-Pacific market as yet unclear. The price of gas is important as it affects the marginal abatement cost of switching from coal to gas.

The electricity sector is already subject to a wide range of emissions reduction policies. In addition to facing the full cost of the carbon price – compensation to generators is for asset value loss rather than scheme compliance – there is the 20 per cent Renewable Energy Target (RET). Given the current state of demand, the 41,000 GWh renewable energy target looks more likely to represent a target closer to 25 or 26 per cent. On the demand side, there are a plethora of energy efficiency measures. Three states and one territory have imposed energy efficiency "white certificate" schemes that require reductions in electricity usage. On top of this there are building standards, appliance standards, the Energy Efficiency Opportunities scheme, and grants to businesses and households. Logically these will drive emissions reductions in the electricity sector regardless of the level of the carbon price.

The esaa is also intrigued as to what form these milestones will take: absolute emissions, the emissions intensity of electricity generation, or the amount of renewable capacity or generation in the market could all be plausible indicators of effort from the sector reduce its emissions. But looking at any of these in isolation does not tell the full story about what is driving these changes and whether they have been achieved in an economically efficient way.

While these concerns are relevant to the electricity sector, many of them will be generic to other sectors, which will also have their particular issues. The direct combustion sector for example will also be subject to economic drivers such as deindustrialisation and fuel pricing.

When we consider that the Authority will be looking ahead to 2050 it is even harder to gauge how milestones should be determined. Taking all these factors into account we recommend that the CCA do not set milestones for the electricity sector at this stage.

If the CCA is intent on setting milestones nonetheless, we urge that a specific consultative process be set up to develop a framework for the development and review of milestones for any sector that will be subject to them. The Authority should be cautious in how it sets and how it reviews these milestones. It is far too complex an area to be considered in a 'tick-or-cross' manner. There does not appear to be

any need to complete the development of milestones on the same time frame as the Caps and Targets review.

Other issues

The CCA asks how Australia's additional permits from the first Kyoto Protocol commitment period should be managed. The esaa considers, in line with one of the Authority's proposed approaches, that it would be best to set these units aside for insurance purchases in case Australia is unable to meet its second commitment period target. Keeping these units in reserve would allow for increased economic growth to be managed in an orderly fashion with a reduced risk of a high carbon price.

Conclusion

There are a range of considerations the CCA should make in its review of scheme caps. In order to provide a signal for long-term investment, it is important that the energy supply sector has an indication on the long-term pathway of caps and targets. Using a gateway system with high and low range values for targets over a period of 10 years beyond the 5-year scheme cap would go some way to providing this detail. It is also important that the Authority refrains from setting strong expectations that one sector or another is primarily responsible for meeting Australia's targets. The carbon pricing mechanism is designed to be an economically efficient response to the emissions reduction challenge by eliciting abatement from the cheapest sources. The design of scheme caps, targets and milestones should reflect this.

Any questions about our submission should be addressed to Ben Pryor, by email to ben.pryor@esaa.com.au or by telephone on (03) 9205 3103.

Yours sincerely

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