# Chapter 3. Prospects for improvement under the Emissions Reduction Fund

The ERF, which is replacing the CFI, contains a number of new and altered elements, and some aspects are still under development. The ERF has been introduced through amendments to the CFI Act, so it falls within the scope of this review.

It is not yet possible to evaluate the performance of the ERF, as it is only just commencing and no auctions have been held. As a result, this chapter examines the extent to which the design of the ERF addresses the problems with the CFI identified in Chapter 2. It also considers new or expanded challenges that may arise, particularly in light of the expanded scale and scope of the scheme.

## 3.1. The Emissions Reduction Fund incorporates some important improvements

Several changes under the ERF are likely to facilitate greater participation in the scheme and, provided there are effective governance arrangements in place, are unlikely to pose a significant threat to its environmental integrity.

### 3.1.1. Investment certainty provided through fixed-length contracts with government

Uncertainty about future prices for credits was the main factor discouraging participation in the CFI (Chapter 2). The ERF addresses this issue by providing price certainty over a fixed-length contract period.

Under the ERF, the government will purchase emissions reductions, in the form of ACCUs, through a reverse auction or other purchasing process. The CER will enter into contracts with successful bidders, which will guarantee the price paid for delivery of ACCUs over the life of the contract. The duration of ERF contracts will typically be seven years or less. Draft rules under the ERF create scope, however, for the CER to enter into contracts of up to 10 years for projects with a crediting period of more than seven years (DOE 2014a). The secondary market for ACCUs is likely to continue, to meet demand from ERF participants needing to ‘make good’ on contract volumes and from the voluntary market.

By providing a fixed price for up to seven years, the standard ERF contract is likely to be attractive to many project proponents—particularly those with projects that generate a relatively large proportion of emissions reductions in their early years (for example, many energy efficiency projects). Projects will, however, need to be developed and registered without any guarantee of success at auction. Accordingly, proponents with projects that would take a long time or be costly to develop would need to weigh up the risks of participating.

The extent to which the ERF is likely to stimulate investment in new projects that generate emissions reductions over a longer time (for example, afforestation) is more uncertain (section 3.2.1).

## Conclusion

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| C 3. By providing a fixed price for up to seven years, the standard ERF contract is likely to be attractive to many project proponents—particularly those with projects that generate a relatively large proportion of emissions reductions in their early years. |

### 3.1.2. Improved approach to method development and approval

The lack of a coordinated approach to method development under the CFI is likely to have created unnecessary transaction costs and inhibited participation (Chapter 2). To address this problem, the ERF introduces a new approach to method development and approvals, which includes:

* prioritising methods for development
* allowing more broadly applicable activity methods
* allowing facility-based methods
* allowing baselines based on emissions intensity.

As at 11 December 2014, the Department of the Environment had issued 17 draft ERF methods for public consultation, including methods for facilities, coal mining, transport, industrial fuel and energy efficiency, and commercial building energy efficiency (DOE 2014b).

The Emissions Reduction Assurance Committee (ERAC) will assess methods and advise the Minister for the Environment on their suitability (in a similar manner to its predecessor, the DOIC). In deciding whether to approve a method, the Minister will have regard to offsets integrity standards and any advice provided by the ERAC. Importantly, the Minister must not approve a method if the ERAC advises that the method does not comply with the offsets integrity standards.

The ERAC will monitor and review the effectiveness of emissions reduction methods over time and review each method at least once every four years. A key focus of the reviews will be to ensure that emissions reductions credited under methods continue to be genuine and additional. The ERAC will also have the power to suspend methods that do not comply with the standards.

During consultation for this review, many stakeholders supported the new approach to method development and approvals, including the government playing a more central role. Likely benefits of this process include:

* targeting government resources to the most prospective methods for reducing emissions
* avoiding narrow methods that limit competition and/or have very limited uptake
* promoting a more consistent approach to managing risks, both within and between methods.

Stakeholders cautioned that there are a number of risks associated with the new approach (discussed below), and stressed that streamlining efforts should not undermine the integrity of the scheme.

#### Better prioritising method development

Under the CFI, anyone could propose new methods to the DOIC for assessment. The ERF has removed this process.

Under the ERF, the Minister for the Environment will determine priorities for developing methods, with advice from stakeholders and the ERAC, and taking account of:

* the potential uptake of the method and the likely volume of emissions reductions
* whether emissions reductions can be estimated with a reasonable degree of certainty and at an acceptable cost
* whether the activity could have adverse social, environmental or economic impacts
* whether the activity could be promoted more efficiently through other government measures (DOE 2014d).

The Department of the Environment will work with stakeholders through technical working groups to develop priority methods and identify priorities for future method development.

Some stakeholders expressed concern that a more centralised approach to method development could inhibit innovation. For example, government agencies may not be as well placed as individuals or businesses with specialist knowledge to identify new, low-cost abatement opportunities. As illustrated in Chapter 2, however, to date government-led methods have generated more credits than private-led methods (both in total and on average per method).

Further, the ERF includes measures that should mitigate this risk to some extent. Technical working groups (with relevant expertise in different sectors) and other individuals and businesses will be able to suggest methods for prioritisation (DOE 2014c). Nevertheless, it will be important that the Department maintains close links with the scientific community to ensure it remains informed of new abatement opportunities in sectors such as agriculture.

Another concern is the potential politicisation of the process. For example, interest groups could lobby to have methods for their projects prioritised over other methods that have stronger claims against the prioritisation criteria. Similarly, there may be a temptation for government to prioritise methods that are popular but have demonstrably high costs or a high risk of non-additionality.

One way to address this concern would be for the Minister to publish the reasons for prioritising or not prioritising particular methods, along with any accompanying analysis. This would, however, place additional demands on the Department’s resources.

#### More broadly applicable and consistent methods

The ERF will allow a range of methods to cater for different sectors and activities. Where possible, methods under the ERF will be designed to apply broadly to similar activities, across a range of business circumstances.

The government has indicated that activity methods will be developed for specific emissions reduction activities, such as landfill gas capture, energy efficiency and land sector projects. Existing methods, for example from the Clean Development Mechanism, will be adapted where they meet the requirements of the ERF. Where appropriate, the ERF will also draw on existing activity methods developed under state-based energy efficiency schemes to develop nationally consistent methods (Commonwealth of Australia 2014).

For complex projects with the potential to deliver large volumes of genuine emissions reductions over a longer period, the ERF provides for bespoke methods (Commonwealth of Australia 2014).

While standardising methods under the ERF could encourage greater participation, there will be trade-offs:

* If a method sets a very standardised baseline, this leaves less room to consider project-specific variables. For heterogeneous activities, this runs the risk of crediting non-additional abatement or excluding additional abatement.
* Making methods less prescriptive could reduce the costs and the time it takes to develop them, potentially making them more broadly applicable. This needs to be weighed against the increased costs of determining and approving baselines at the project development and approval stage.
* To remain robust and reduce the risk of non-additionality, methods need to be updated over time to incorporate the latest information (CCA 2014a).

Project-specific additionality tests, such as financial and barrier analysis, may be appropriate for large one-off projects for which standardised tests are not well suited (CCA 2014a). This has direct relevance to the development of ‘bespoke methods’ under the ERF (section 3.2.2).

Several stakeholders observed that some of the draft methods released for public comment were very broad and should be complemented with plain English guidance on how to comply. (The CER will be issuing further guidance on participating in the ERF.) The very broad nature of some draft methods raises questions about whether it will be possible to apply them without increasing risks to environmental integrity (section 3.2.2).

#### More consistent approach to managing risks

Some stakeholders have suggested that the CFI over-emphasised scientifically-rigorous measurement of emissions, without really considering whether the prescriptive requirements imposed were proportionate to the risks. For example, some methods required a high level of accuracy for inputs that were unlikely to have a material effect on the overall estimate of emissions.

Stakeholders suggested that the inconsistent application of stringent rules, both within and across methods, compounded this problem. For example, CFI methods sometimes required a relatively low standard of evidence for important inputs for measuring emissions, introducing inaccuracies that nullified the benefits of high standards for other inputs. Similarly, it was suggested that the DOIC/ERAC should put more emphasis on managing the risk of non-additional projects rather than the risk of inaccurate measurement of emissions.

The new approach to method development should help promote greater consistency in managing risks. For example, the ERAC will be required to consider the advice from the CER about method implementation, which should help ensure that methods are workable, do not create undue compliance burdens, and are broadly consistent with each other. Periodic reviews of methods by the ERAC may also identify opportunities to enhance consistency.

#### Facilities methods

The Department of the Environment is currently developing a facilities method (using existing data under the National Greenhouse and Energy Reporting Scheme) to encourage emissions reductions from a wide range of activities. This method is limited to facilities that already report under the National Greenhouse and Energy Reporting Scheme and produce an output.

Facility methods are less common than activity methods in voluntary crediting schemes in Australia and other countries but, once established, can provide greater flexibility in the types of activities undertaken, and reduce measurement and audit costs (compared with activity methods) (CCA 2014a).

While many stakeholders supported the idea of a facility-wide method, some were concerned that the draft ERF facility method was so broad that, if approved in its current form, it might be difficult to implement without introducing risks to the integrity of the scheme (section 3.2.2). There will be an opportunity to address these concerns in the final ERF facility method.

#### Methods based on improvement in emissions intensity

To allow more types of projects to participate, the ERF will allow methods based on improvements in emissions intensity as well as methods based on absolute emissions reductions. This would allow credits to be issued for improvements in the emissions intensity of production even where production is expanding and absolute emissions increase.

Intensity baselines can play a useful role in crediting mechanisms, depending on the specific nature of the activity, and the availability and suitability of the activity data. Issues to consider include:

* All baseline emissions are a product of the baseline activity (the action that would occur in the absence of the project) and the baseline emissions factor of that activity (emissions per unit of baseline activity).
* Intensity baselines assume that baseline activity is equal to actual activity, which is a reasonable assumption provided that undertaking the project does not influence activity levels. If the additional income from crediting makes it worthwhile to do more of an activity, then actual activity is not a good proxy for baseline activity. In these circumstances, an intensity baseline would lead to over-crediting. An absolute baseline that estimates activity in advance would be better.
* Intensity baselines are more challenging if an activity is not easily defined. For example, intensity baselines could be measured in terms of a unit of input or output (such as tonnes of CO2-e per square metre of building space used) but are more challenging if, for example, a facility produces multiple products.

Many energy efficiency and displacement methods from other schemes use intensity baselines. For example, the New South Wales ESS methodologies use improvements in building energy efficiency. The baseline is the emissions intensity of the floor space in the building (kgCO2/m2) required by regulation (CCA 2014a).

### 3.1.3. Streamlined additionality assessments

To demonstrate additionality under the CFI, proposed activities or types of projects had to go beyond common practice (and be included on what was known as the ‘positive list’), and not be required to be carried out by law.

To reduce transaction costs and encourage participation, the ERF removes the common practice test and the positive list and focuses additionality testing primarily in method development. While the positive list was originally designed to give early guidance to participants designing bottom-up methods, feedback from stakeholders suggests that in practice the process has been duplicative and time-consuming. As a result, the new approach should streamline the scheme and reduce costs for project proponents. The more centralised method development process under the ERF weakens the justification for the positive list.

While removing the positive list may eliminate duplication, the core task of determining which activities create real and additional emissions reductions remains. This will require more than an examination of historical activity; it will also require an assessment of whether the activities would have occurred anyway (CCA 2014a).

### 3.1.4. More flexible reporting and verification

#### Risk-based audits

Under the CFI, project proponents received credits after submitting project reports and completing an application. All project reports had to be accompanied by a reasonable assurance audit report, with minor exceptions in the CFI regulations.

For some types of activities, auditing costs may have impeded participation in the CFI (Chapter 2). For example, project developer Fares Rural argued that the cost of current audit requirements is significant for sequestration projects, making many small projects unviable (sub. 3, p. 4). The Aboriginal Carbon Fund (2014) similarly noted that audit costs can be prohibitive for savanna burning projects. More broadly, placing onerous auditing requirements on low-risk projects is likely to impose costs for little, if any, environmental benefit.

To make it easier and less costly to participate in the scheme, the ERF removes the universal requirement for an audit report and introduces a risk-based approach to auditing emissions reductions. Under this approach, the CER will determine project audit requirements taking into account project risks and the risk profile of project proponents. This is likely to mean that proponents undertaking relatively small, uncomplicated projects could expect fewer audits than those undertaking projects that are more complicated (CER 2014).

While many stakeholders expressed in-principle support for risk-based audits, several noted that they would require further details before coming to a firm view. The CER is currently developing rules on the level of assurance, frequency and scope of the audit report that must be provided for different types of projects under the ERF (CER 2014, DOE 2014a).

Clear Environment, a consulting firm that provides assurance services under various environmental schemes, argued that audits should be mandatory prior to every issuance of credits. It argued that material misstatements were common in the CFI, and that if material issues were only identified after credits had been issued, project owners could face hardship due to obligations to then ‘make good’. It also argued that the proposed approach would significantly increase the administrative burden on the CER, as it would have to develop audit and assurance requirements on a case-by-case basis. (sub. 6, p. 1)

In principle, a well-designed risk-based audit regime should reduce transaction costs without eroding the environmental integrity of the scheme or creating other adverse impacts. For example, higher risk project proponents (such as those who have limited or no experience with similar schemes, who are using a new method, who are contracted to deliver large volumes of emissions reductions or who have a history of material misstatements) could continue to face the strict auditing requirements that applied under the CFI. Hence, they would pose no additional risk to the integrity of the scheme.

The practical challenges associated with designing an effective risk-based audit scheme are not trivial. A more conservative approach might be warranted in the early stages of the scheme to allow time to address any teething problems.

#### Flexibility to report more frequently

In addition to risk-based auditing, the ERF allows project proponents to report emissions reductions more frequently, which in turn allows them to access revenue from selling their credits more frequently. Under the CFI, the minimum reporting period was 12 months. Under the ERF, reporting can occur as frequently as every six months (or less if prescribed by legislative rules).

Draft rules under the ERF specify a minimum reporting period of one month. To avoid obliging the CER to process large numbers of reports for a small amount of abatement, proponents will only be able to report more frequently than every six months if they generate abatement of more than 2000 t CO2-e for the reporting period (DOE 2014a).

Stakeholders generally supported the enhanced flexibility. One noted that, in addition to providing participants with more frequent cash flows, more frequent reporting could reduce the reporting bottlenecks that occur under a 12-month reporting cycle.

## Conclusion

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| C 4. Changes to streamline the ERF are likely to result in lower transaction costs than for the CFI, in many cases without adversely affecting emissions reductions. The ERF approach to method development and approval appears to represent an improvement from the CFI approach, but much will depend on implementation. |

## 3.2. The Emissions Reduction Fund creates some new or expanded risks

As well as improvements, the ERF creates some new or expanded risks relative to the CFI. These risks will need to be well managed if the scheme is to achieve its objectives.

### 3.2.1. The design of the new scheme might not support long-term investments

Experience in Australia and other countries demonstrates that uptake of emissions reduction programs will inevitably be affected by perceptions of a scheme’s likely stability and longevity, and that uncertainty about the policy time horizon will deter participation (CCA 2014a). Some activities, such as those that generate emissions reductions over a longer time period and/or have high upfront costs, require confidence that an incentive will be provided over the long term. Under the ERF, the crediting period for some activities, such as sequestration projects, will be up to 25 years.

Projects face uncertain (and potentially low) prices for any credits generated beyond the initial ERF contract period, which will be typically for seven years or less. As ERF support is limited to a single contract period, sales of credits beyond that would therefore rely on the secondary or voluntary market, including possible demand from entities with liabilities under the ERF safeguard mechanism. Current indications are that baselines under the safeguard mechanism will be set in a way that would be, at least initially, unlikely to create strong demand for credits (Chapter 1). This issue will be explored in the design of the safeguard mechanism; in the meantime it is hard to project the demand for credits that it may generate.

Other areas of uncertainty affecting investment decisions include the specific operation of the ERF (including likely auction prices and rules), the longevity of the ERF, and broader climate policy settings including for the RET, particularly in light of the lack of bipartisan agreement on climate change policy.

Uncertainty about future demand for credits is likely to most affect activities that generate emissions reductions over a longer time and have high upfront costs. These projects will require relatively higher prices to participate in the ERF, to account for the uncertain returns beyond the contract period. In turn, this might render many of these projects uncompetitive relative to projects that generate a lot of emissions reductions in their early years of operation (Box 1). Moreover, lenders might be reluctant to finance long-term projects that do not have a relatively secure long-term revenue stream; these challenges are similar to those facing renewable energy investors (CCA 2014b). Existing CFI project operators who have approved methods and who are able to backdate projects might be the exception.

Draft rules on the duration of contracts give the CER the ability to enter into contracts of up to 10 years for projects that have a crediting period of more than seven years. The extent to which this mitigates risks for long-term projects remains to be seen, and will in part depend on the precise circumstances in which 10 year contracts are made available. Further, even 10 years might prove an insufficient incentive for activities that deliver abatement over an extended period (for example, afforestation).

## Conclusion

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| C 5. Given uncertain and potentially low prices for credits beyond the ERF contract period, standard seven-year contracts (and even 10-year contracts) might not provide sufficient incentive for some long-lived investments that deliver abatement over an extended period, thereby excluding some low-cost opportunities. |

### 3.2.2. There are risks to environmental integrity

Unlike the CFI, which was a comparatively small land-based program that complemented the carbon pricing mechanism, the ERF is the centrepiece of the Australian Government’s Direct Action Plan to reduce emissions. Expansion of coverage and the current funding commitment of $2.55 billion have the potential to significantly scale-up activity relative to the CFI. This scaling-up of activity magnifies the significance of risks to environmental integrity under the scheme.

Expansion and streamlining of the ERF are likely to result in additionality rates declining somewhat. Provided the decline is small and compensated by lower transaction costs and greater participation, this ‘rebalancing’ would constitute an improvement. However, buying a large volume of non-additional emissions reductions would erode the scheme’s cost-effectiveness, crowd out genuinely additional reductions and reduce the scheme’s contribution to meeting Australia’s targets (Chapter 4).

The expanded scale and scope of the ERF requires new expertise, capacity and consultation mechanisms to be developed in a relatively short time. Developing robust methods for many new activities will be challenging, particularly as the scheme is expanding into areas where it is inherently difficult to judge additionality (such as energy efficiency) (Chapter 1). There is a risk that additionality rates could decline sharply.

As noted above, the ERF includes some features that will help manage this risk; for example, technical working groups to leverage industry and other expertise, scrutiny by the ERAC, including periodic reviews of methods, and provisions to suspend methods. The Department and CER have also acquired important experience and expertise through the CFI.

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| ****Box 1:**** Contract length and timing of emissions reductions The ERF is designed to provide certainty for participants through contracts for emissions reductions; giving them confidence they can recover costs and achieve an appropriate return. However, the benefit of this certainty is limited by contract length. Projects that generate ERF credits beyond the contract period face considerable uncertainty on future returns for credits. This creates an incentive for proponents to try to recover all their costs within the contract period. This dynamic favours projects that realise a large proportion of credits within the contract period. Figure 14: Project with a seven-year crediting period Figure 14: Project with a seven-year crediting period Figure 14 illustrates an Emissions Reduction Fund (ERF) project that involves an upfront capital investment with a life of around seven years (for example an industrial energy efficiency project). The project is assumed to have a seven-year crediting and contract period. The project generates a steady stream of emissions reductions over the period and all of its credits are created within that period, so the project proponent does not have to factor in future demand risk when bidding into the ERF.  Figure 14 illustrates an ERF project that involves an upfront capital investment with a life of around seven years (for example an industrial energy efficiency project). The project is assumed to have a seven-year crediting and contract period. The project generates all of its emissions reductions (and all of its credits) within that period, so the project proponent does not have to factor in future demand risk when bidding into the ERF. Figure 15: Project with a 25-year crediting period Figure 15: Project with a 25-year crediting period Figure 15 illustrates an Emissions Reduction Fund (ERF) project with a 25-year crediting period and large upfront capital costs—a reasonable proxy for afforestation, for example. The number of emissions reductions increases each year, and only a small proportion of credits are generated within the seven-year contract period, so the project faces substantial future demand risk. As a result, the project proponent may need to bid a high price per credit into the ERF to make the project financially feasible.  Figure 15 illustrates an ERF project with a 25-year crediting period and large upfront capital costs—a reasonable proxy for afforestation, for example. Only a small proportion of credits is generated within the seven-year contract period, so the project faces substantial future demand risk. As a result, the project proponent may need to bid a high price per credit into the ERF to make the project financially feasible. |

An increase in the contract length from seven to 10 years would increase the number of credits over which the project proponent could recover a return (helping improve the project’s competitiveness). However, the project proponent would still face considerable demand uncertainty, which may still deter the investment.

Very broad methods that apply across a range of projects, with different characteristics and investment drivers, could make it more difficult to establish additionality. Greenhouse Gas Consulting Services observed:

Some of the current [method] determinations have a scope that is wider than the previous determinations and the need to cover this wide scope has increased their complexity. This increase in complexity makes it difficult to follow the [method] within the determination and understand any particular requirements. A complex determination can result in … the content of the determination not matching its intent …The wide scope has resulted in some determinations not covering issues with the possible projects that can be included in those determinations. (Greenhouse Gas Consulting Services, sub. 17, p. 2)

The inclusion of even a small number of methods with questionable additionality can significantly erode the environmental integrity of these types of offset schemes. Under the Alberta Offset program, for example, projects that reduced or eliminated tillage of agricultural soils to increase carbon sequestration generated 38 per cent of offset credits used between 2007 and 2012 (CCA 2014a). As low tillage was already a relatively well-established practice, however, it is likely that many of the funded projects were not additional.

At present, it is too early to say how all this will play out, and whether the new governance systems and powers will be used effectively.

## Conclusion

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| C 6. Expansion and streamlining of the ERF are likely to result in additionality rates declining somewhat. Provided the decline is small and compensated by lower transaction costs and greater participation, this ‘rebalancing’ would constitute an improvement. There is a risk, however, that these changes could cause additionality rates to decline sharply, particularly as the scheme is expanding into areas where it is inherently difficult to judge additionality (such as energy efficiency). |

#### Large projects and additionality

While project-level additionality tests, such as financial and barriers analysis, can be resource-intensive and time-consuming, they are likely to be warranted for projects that generate a large amount of credits—particularly in the industrial sector where there is often too few comparable facilities to apply standardised approaches, such as common practice tests. These tests would apply to large projects regardless of whether they are using a ‘bespoke’ method or more generic method.

The Department, in consultation with the CER and other stakeholders, should consider introducing enhanced additionality tests (such as financial and barrier analysis) for individual projects that generate a large volume of credits under the ERF. Issues to consider include:

* the appropriate threshold for applying enhanced additionality tests
* their appropriate design
* the potential for perverse incentives (such as encouraging proponents to split up larger projects into smaller projects to avoid enhanced additionality tests).

## Recommendation

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| R 1. The Department of the Environment, in consultation with the Clean Energy Regulator and other stakeholders, should consider introducing enhanced additionality tests for individual projects that generate a large volume of credits under the ERF, with particular regard to the financial viability of the project in the absence of ERF support. |

## 3.3. There are some problems that the Emissions Reduction Fund cannot address

The ERF cannot address all the problems associated with the CFI. Some have arisen because of the general limitations of project-based baseline and credit schemes. Other perceived ‘problems’, such as lack of participation by certain sectors, partly reflect the economic and practical realities of taking action in those sectors.

### 3.3.1. Limitations of baseline and credit schemes

Like all emissions reduction measures, baseline and credit schemes have their disadvantages. As discussed earlier, one of the main disadvantages relates to the complexity of determining what would have happened to emissions in the absence of the scheme (that is, developing baselines and determining additionality).Government will often have limited information about cost structures and other factors influencing investment in different industries. This information asymmetry gives project proponents a financial incentive to engage in gaming, such as overstating financial barriers to investment, or arguing for a relatively generous baseline (above business-as-usual) to increase the number of credits received. Professor Garnaut has previously suggested:

Additionality is particularly difficult in a financial context … it actually requires clairvoyance to know whether or not, on financial grounds, an investor would have made an investment. So in the end you need to use rules of thumb—which, by the nature of things, are imperfect. That does not mean to say it is not worth doing, but you are certainly working with approximations. (Committee Hansard, Senate Environment and Communications References Committee Inquiry into the Government's Direct Action Plan, 7 March 2014, p. 4)

Information asymmetries also mean that some low-cost abatement opportunities will inevitably be missed because it is not feasible to devise methods and baselines that would credit these opportunities without also crediting many non-additional projects. For example, a firm considering two options for upgrading an industrial facility—one with high emissions and the other with low emissions—could approach the government with a proposal to undertake the low emissions option in return for a government contribution. Because the government has no way of verifying whether the firm would have invested in the low emissions option without assistance, it faces the risk of either forgoing a very cost-effective opportunity (on a dollars per tonne CO2-e basis) or paying a relatively large sum of money for absolutely no additional emissions reductions. In the latter case, there would be less money to buy additional reductions.

The Climate Institute (2014, p. 5) has argued that state-based energy efficiency schemes have demonstrated these pitfalls.

The rapidity with which energy efficient technologies were taken up through the state schemes and diffused more broadly through the market meant that certain technologies became ‘common practice’ long before government systems were able to update their eligibility criteria. Given the breadth of activities able to reduce emissions, the Emission Reduction Fund will face an even greater challenge to ensure it credits only genuinely additional emission reductions.

Recent research by the Authority, which draws on experience from domestic and international baseline and credit schemes, further highlights the inherent limitations and complexities in crediting emissions reductions (CCA 2014).

## Conclusion

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| C 7. Domestic and international experience suggests there are inherent limitations and complexities in crediting emissions reductions. The ERF purchasing scheme will inevitably miss some low-cost abatement opportunities because it is not feasible to devise methods and baselines that would credit these opportunities without also crediting many non-additional projects. |

### 3.3.2. Emissions reduction measures are inherently costly in some sectors

Limited participation in the CFI by particular activities or sectors is not necessarily a sign that there is a problem. In fact, it can be a sign that measures to ensure environmental integrity are working. For some activities or sectors, transaction costs are likely to remain unavoidably high because their characteristics necessitate relatively complicated methods to ensure abatement is real and additional. In the agriculture sector, for example, there are challenges associated with measuring and verifying emissions reductions in natural systems that have high levels of local variability (CCA 2014a). These challenges are exacerbated where projects only achieve a small quantity of emissions reductions, as transaction costs can quickly become high on a per tonne CO2-e basis.

While transaction costs can be reduced through streamlining (for example, by using modelled abatement estimates rather than direct measurement), there is only so much that can be done before the risk to environmental integrity becomes unacceptable.

Lack of participation by particular activities and sectors may also reflect that abatement options in those areas are not cost-effective. For example, analysis by researchers from the University of Melbourne suggests that few soil carbon projects are likely (based on a credit value of $24.15/t), as the land management and land use changes required to achieve a consistent and verifiable increase in soil carbon are rarely to the financial benefit of a farmer (White & Davidson 2014). The Australian Dairy Industry Council observed that opportunities for abatement from soil carbon are particularly limited in the dairy industry (sub. 1, p. 14).

To the extent an objective of the ERF is to achieve lowest-cost abatement, one would expect higher cost sectors to have low representation.

## 3.4. Striking the right balance—scheme participation and additionality

Many of the changes under the ERF involve trade-offs between encouraging scheme participation and ensuring the genuine additionality of emissions reductions. For example, more standardised methods could increase the number of businesses willing to put forward proposals by reducing transaction costs, but provides less scope to consider project-specific variables.

Striking the right balance will always involve some degree of judgment and learning. The CFI placed a reasonably heavy focus on additionality and accurate measurement of emissions, and required participants to adhere to relatively prescriptive rules. In the ERF white paper, the government signalled an increased emphasis on making it easy for business to participate in the scheme through streamlined administration.

Governance arrangements will play an important role in minimising new or expanded risks under the ERF. The ERAC and CER will need to be nimble so they can respond to unexpected problems in a timely manner. Transparent processes and independent scrutiny of the scheme’s progress will help promote accountability.

CFI features maintained in the ERF can help manage risks. For example, the ERAC can effectively veto methods it considers inconsistent with the offsets integrity standards. This helps protect environmental integrity from political pressure and lobbying. ERAC’s regular review of methods and ability to suspend methods together provide a backstop should problems arise following the approval of a method. This will help ensure activities that have become non-additional are transitioned out of the scheme in a timely manner. (As noted in Chapter 1, the government has also stated that it will review operational elements of the ERF towards the end of 2015.)

It is important that these backstop measures do not become a substitute for rigorous method development and approval processes, as problems undermine the environmental integrity of the scheme until the government is able to close any ‘loopholes’. Variations to methods will not apply retrospectively, so any non-additional projects that have entered into contracts will continue to receive funding for the period of those contracts.

The effectiveness of the ERF’s governance arrangements will ultimately depend on details contained in legislative rules and final methods, as well as other factors such as the resourcing of relevant agencies, and the quality and experience of staff and committee members. Several stakeholders noted the importance of providing the Department of the Environment with adequate resources for method development.

## Conclusion

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| C 8. Governance arrangements for the ERF will need to be responsive to unexpected problems andrender new projects ineligible should they become non-additional. |

Due to the short timeframe for this review, the Authority was unable to consider all proposed options for improving the CFI. Appendix B outlines some further issues that may warrant consideration in the future.