GRATTAN Institute

Minimising the carbon pain

Published in The Australian Financial Review, page 63, Thursday 15 July 2010

Doing nothing on emissions is an extremely costly option, write ***John Daley and Tristan Edis.***

The climate change debate is inevitably influenced by the desire to minimise short-term political pain. Clearly, reducing carbon emissions is not going to be painless. However, doing nothing is also going to be painful. And measures that minimise the short-term political pain are liable to substantially increase the long-term economic cost.

All major political parties are maintaining their commitments to cut 2020 carbon emissions to at least 5 per cent below 2000 levels. This is a substantial cut. It involves reducing carbon emissions 22 per cent below "business as usual" levels after taking into account population and economic growth to 2020, as well as existing emission reduction policies such as the Renewable Energy Target. Even if we reduce the emissions from Australia's current planes, trains and automobiles to zero, we'd still reduce emissions by only 12 percent of business as usual.

Almost by definition, cutting emissions requires less coal-fired electricity generation. The proposal for an obligation on energy companies to help their customers save energy through subsidising energy-efficient products may be worthwhile. But even if we implemented every energy-efficiency measure identified in a recent study by ClimateWorks and McKinsey, we will cut emissions by only 10 per cent. To cut them by 22 per cent below business as usual we have to replace coal-fired electricity with alternative energy sources.

Wind, solar, biomass and geothermal will all help. But if they are going to give the committed 22 per cent cut, they will be costly – and these are costs that Australians must ultimately pay either as taxes or as higher electricity prices. The cheapest and most feasible way to substantially cut electricity generation emissions by 2020 is to use gas rather than coal as fuel for power stations.

However, it will take time to execute a managed retirement and replacement of Australia's high polluting coal-fired electricity generators. Building a new, low-emission, high-efficiency gas power plant takes five to six years. Until there is firm policy in place for carbon pricing or direct subsidies, commercial players are unlikely to start building.

Governments could defer policy decisions, and some of the immediate political pain. However, if they retain their commitment to carbon reduction targets, they are implicitly committed to costly actions in the future to reduce emissions quickly. And the cost of interrupted electricity supply is enormous relative to the costs of building new power stations.

Doing nothing will impose higher electricity prices anyway, but without reducing emissions. A recent study by staff at energy company AGL outlines that the current uncertain policy environment encourages industry to play it safe by making greater use of high operating cost, inefficient power plants, because they don't require much upfront capital. Potential builders of coal plants are reluctant to invest in today's cheapest option because it might not be competitive in 10 years' time. They have fair warning that many politicians are promising to raise carbon prices. At the same time potential builders of energy-efficient, low-carbon emission gas power plants are reluctant to invest because they are not competitive today, and there is no guarantee of a carbon price within the next few years.

This uncertainty simply creates a $2 billion a year dead-weight cost that everyone must pay for. The only alternative is direct subsidies for producers to invest in new gas-fired plant, or alternative technologies. This has the short-term advantage of minimising the political pain. There is no "great big new tax" to demonise. Instead there will simply be increases in other pre-existing taxes to pay for the required government subsidies. Ironically, we have spent the last few decades dismantling direct government investment in electricity generation in Australia, and discovered that this substantially reduced the costs of building and running electricity plants.

The most high-profile action – setting a carbon price sooner rather than later – is likely to turn out to be the least economically painful. The actual economic impact of imposing a carbon price will be limited for most people. Grattan Institute's report, Restructuring *the Australian economy to emit less carbon*, demonstrated that the impact of carbon pricing to 2020 on household budgets will be limited, and small compared to other cost increases we have experienced over the past 10 years. The impact on industry will also be limited – many emissions-intensive industries such as alumina refining are unlikely to shift offshore as a result of carbon pricing.

John Daley is chief executive of Grattan Institute and Tristan Edis is a research fellow there.

John Daley
CEO, Grattan Institute
Contact: 03 8344 6142 or 0407 004 231

Tristan Edis
Research Fellow, Grattan Institute
Contact: 03 9035 8186 or 0421 185 482