

www.grattan.edu.au

Hybrid scheme the best of both worlds for cutting carbon

Published in the Age, page 17, Friday 24 September 2010

*A mix of "cap and trade" and emissions taxes is needed to do the job, writes **John Daley and Tristan Edis.***

Imagine you could only sell your house by auction, but weren't allowed a reserve price. Doubtless auctions would be more exciting, with buyers hoping for a bargain. But it is also likely that house prices would fall. Many people would fear to invest in housing in case they sold on a bad day.

Energy investors face the same issues with carbon pollution prices, even if the price tags are bigger. Investors in less polluting energy - such as gas, wind and solar power - worry that the carbon price may turn out to be too low. If it is, they won't make enough to justify investing.

That is why the debate about carbon pricing has turned to "carbon taxes". Taxes provide more certainty of making a profit on energy investments. However, unlike the "cap and trade" policy proposed last year in the Labor government's carbon pollution reduction scheme, carbon taxes provide less certainty of big enough cuts in emissions.

A hybrid scheme - a trading scheme with a floor price, a bit like a house auction - would be the best of both worlds. It would reduce uncertainty and, ultimately, the costs of cutting carbon pollution.

Carbon pricing is a key issue when building new power stations. Major private sector energy companies in Australia are not seriously considering building coal-fired power stations in eastern Australia, and banks aren't likely to be keen to lend money for such projects, either. Instead, they are planning lower-carbon, baseload power stations using gas.

This is exactly the point of carbon pollution prices. We need these new power stations to keep up with rising energy demand and ultimately replace high-pollution power stations such as Hazelwood. But it only makes sense to invest if gas-fired generators cost less to operate than coal-fired generators (including paying for carbon pollution).

A "cap and trade" scheme caps the maximum amount of carbon dioxide that can be emitted each year. Polluters need to buy a permit for each tonne they emit. If there are fewer polluters than permits, then permit prices can crash.

This has already occurred with environmental permit trading schemes in Europe and the US, and with Australia's three existing trading schemes. Unlike normal markets, the supply of permits is fixed by the government, and does not reduce with lower prices.

A simple levy on carbon pollution gives investors more confidence. It becomes cheaper to finance new power stations, and ultimately consumers pay lower electricity prices. Companies that emit carbon pollution directly, such as chemicals manufacturers, think the same way - with more certainty, they will be quicker to invest in their plant to reduce emissions.

The problem with a levy is that it does not guarantee how much carbon we emit. Trading schemes also cushion the economy during recessions: when the economy slows, emissions fall and carbon prices fall.

The best solution may be a "hybrid" scheme, where for each tonne of carbon dioxide emitted, polluters must both pay a levy and purchase a permit.

In effect, this sets a floor-price for carbon emissions, something like the reserve price in a house auction. It creates more certainty for the builders of power plants, and businesses investing to reduce their direct emissions.

A hybrid scheme would fit with policy around the globe. The European and British schemes appear to be moving towards hybrid designs. The legislation proposed in the US Congress also looks like this.

Established coal-fired generators have the most to lose from a hybrid scheme. Without a floor price, new power generators are slow to invest, electricity prices rise, and existing coal-fired power stations make higher profits. The whole community pays the cost.

At best, a hybrid scheme will reduce emissions like a cap and trade scheme, but at lower cost. Efficient investments will be made earlier. At "worst", a hybrid scheme might result in Australia cutting carbon emissions by more than we intended. By definition, we would only be paying a cost that we were prepared to pay.

Given that Australia has the highest per capita emissions in the OECD, we can probably afford to overshoot. A hybrid scheme would be the best of both worlds. Just like it is for house auctions.

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

John Daley
CEO, Grattan Institute
Contact: 03 8344 6142 or john.daley@grattan.edu.au

Tristan Edis
Research Fellow, Grattan Institute
Contact: 03 9035 8186 or tristan.edis@grattan.edu.au

www.grattan.edu.au