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# Australia's carbon price mechanism: predictability *and* flexibility?

*Published in Carbon Market Australia-New Zealand (vol.4, issue 9, page 6) by Thomson Reuters Point Carbon News, 2 September 2011*

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We need a level of freedom in responding to climate change, as we learn more about the problem and solution. At the same time we – especially those making long-term investments to reduce emissions – want predictability. As part of a policy package, the Australian government's proposed carbon price mechanism balances these competing objectives.

The backdrop to this policy is one of uncertainty. Labor's control of the hung parliament is threatened by a backbencher's scandal, and Tony Abbott continues to fiercely oppose carbon pricing. This uncertainty will pervade parliamentary debate of the government's Clean Energy legislation over coming weeks, and beyond. But, in this tumult, the carbon pricing mechanism outlined in the government's draft legislation offers a predictable framework for a flexible response.

Predictability is notable in the mechanism's beginning with a fixed price, followed by an automatic transition to a floating price, on a definite timetable. The government's climate change adviser, Ross Garnaut, endorsed this model because it offers credibility and steadiness at the outset, as participants and regulators build confidence, but allows the lowest cost emissions reductions in later years, through flexibility afforded by trade.

The cost of reducing emissions is arguably the greatest area of unpredictability in this policy. History shows us that markets created by pollution prices deliver emissions cuts much more cheaply than expected, and in unforeseen ways. A 2010 Grattan Institute report cited evidence of this from Australia's Mandatory Renewable Energy Target scheme, and overseas cap-and-trade schemes. One effect is that prices in pollution markets can be volatile. The proposal for an initial fixed price, followed by a period of pricing bounded by caps and floors, guards against extreme volatility in the early years. The mechanism provides for the future use of overseas permits, like those generated by investing in renewable energy projects in developing countries, or those issued in New Zealand's emissions trading scheme. However, with markets unspecified and prices unknown, this introduces uncertainty about the costs of abatement. Further clarity about the type of credits to be accepted is needed for businesses to manage their liabilities.

By the time the carbon price floats, a firm target for emissions reductions in 2020 – at least five per cent on 2000 levels – will be set. Because Australia's carbon price does not cover all the country's emissions, the mechanism will have its own different, but corresponding, emissions caps. There will be five years of known caps at all times. Though investors would like caps set far in advance, in line with the 20-30 year lives of their emissions-intensive infrastructure assets, these caps are biased towards flexibility, allowing government to make changes within a few years in response to new information.

Arrangements for industry assistance illustrate the tension between predictability and flexibility. The mechanism guarantees certain amounts of free permits, for specific industries. Our research has suggested this assistance is excessively generous – bordering on protectionism – so regular reviews of the outcomes of this assistance program will be important. If the Productivity Commission is unconstrained in undertaking such reviews, and if proposed changes can be implemented swiftly, government and the nation can gain economic flexibility – though at the expense of predictability for industry.

The governance of the mechanism provides both flexibility and predictability, because it relies less on government than on the market and independent bodies. As in the UK, independent authorities will advise on caps and progress towards meeting targets, and undertake scheduled reviews of the carbon price mechanism. There will be an independent regulator. Institutions at arms-length from political wrangling should deliver greater rigor in decision making, which should improve stability and credibility.

The government's package manages the tension inherent in climate change mitigation policies: to set out a clear goal and the policy's likely consequences, but also leave room for innovation and creativity. The proposed mechanism provides much of the direction and confidence that the economy needs.

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