Carbon price floor crucial to its aims

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Emissions would not fall if the base price were lower; write ***Tony Wood, Frank Jotzo, Erwin Jackson, and Cameron Hepburn.***

While the political noise around the carbon laws continues, we risk losing sight of the fact that a minimum carbon price floor guards against the policy becoming a toothless tiger in 2015.

The government, the Greens and independents agreed to keep the carbon price at or above $15 from 2015 to 2018 to provide some degree of confidence for industry to make low-carbon investments.

In the short-term, this avoids the domestic effort being determined by the projected very low price of international offset credits.

Some in business have questioned the need for the price floor, in part based on an argument that price floors are inappropriate interferences in markets. This is misleading. An emissions trading scheme is a policy tool created by government to achieve the objective of reducing emissions.

It is important to get the rules right to ensure the market works to meet its national interest objective: to start the transition to a lower carbon economy.

International credits from projects to reduce emissions in developing countries now trade at less than $5 per tonne because of oversupply and limits on demand from European buyers. We should not fool ourselves that those prices reflect efficient climate policy or the extent of global action. Nor do they reflect the true long-term value of reducing emissions.

Letting the carbon price fall to single digits would compromise incentives to make low-carbon investments, compound uncertainty in the energy sector and increase the long-term cost of cutting emissions.

There's a strong economic case for keeping Australia's domestic price above the fire-sale prices for international credits.

First, it reduces the costs of investments in curbing emissions.

The price of international offset credits has fluctuated between $4 and more than $20 in the past three years. With a floor, predictability is greater as investors can bank on a guaranteed minimum carbon price. This matters for the economy.

Recent analysis by economists at AGL suggests that additional capital costs driven by investors hedging against carbon policy risk will unnecessarily cost $5 billion between 2015 and 2020 in the electricity sector alone.

Second, a price floor helps with long-run economic efficiency. Moving to a low-carbon economy is a marathon, not a sprint. Success means setting policy that offers incentives for companies to start now.

With the possibility of a very low price, investments in low-carbon technologies will be delayed and sequestration projects in forestry and agriculture would be less viable.

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A longer delay in making low-carbon investments will increase the economic costs of meeting longer-term emissions targets. If the price is too low, Australian investors will commit to long-term assets that are too emissions-intensive. To achieve emissions reductions later on, much more will have to be spent.

Third, no major economy has directly coupled its domestic carbon price to that in international carbon credit markets. The European Union places strict limits on the import of credits. Such limits are the alternative to a price floor. For Australia, it would require a drastic cut to the limit on international credits allowed into the scheme.

Australia's floor price of $15 is not high by international standards. The UK's floor price is about $25 a tonne in 2013 and is legislated to rise to $115 a tonne in 2030.

California's floor price will be $11 to $12 a tonne in 2015 and will rise by 5 per cent per year.

Once global emissions markets mature, there is no case for price constraints. But at this stage, without a price floor or quantitative limits, Australia's price would only reflect the excess of supply over demand in the international market.

Once global emissions markets are more developed, and linking between markets is likely, the advantages of full international integration may outweigh the arguments for floors and ceilings. In the meantime, it is important to make sure the Australian carbon price will be effective.

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