

## **Surrender to the charge**

*Published in the Climate Spectator online, Wednesday 7 March 2012*

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In recent weeks a range of industry figures have criticised the federal government's decision to introduce a 'surrender charge' as part of the coming emissions trading scheme. They say that such a charge is an unfair impost that not only hurts business, but unjustifiably increases the cost of meeting Australia's emissions reduction targets.

At the heart of their criticism is a rejection of the scheme's floor price. But if you accept that the floor price has a sound policy rationale, then a surrender charge is essential to ensure the integrity of the scheme. Some explanation is required.

A surrender charge is a charge on businesses that purchase emission reductions units overseas, at a price below the floor price set in the Australian scheme. The charge would top up the cost of purchasing the emissions reduction overseas to ensure that it was the same as the floor price and therefore did not undermine it.

The need for the surrender charge arises from a clash of two policy decisions with the Australian carbon pricing scheme, each with its own reasonable justification. These are:

- 1) The application of a regulated minimum floor price for carbon permits; and
- 2) Recognition of carbon credits sourced from overseas abatement schemes which do not apply the same floor price.

### **The Floor Price**

The Australian emissions trading scheme will be introduced from July 2012 with a fixed price for the first three years. The government has decided that after three years the flexible price period will begin, and over this time a combination of a price ceiling and floor will apply.

The concept of using such an approach has been one of the vigorously debated design principles in the evolution of Australia's emissions trading scheme. Some in industry argue that the imposition of artificial constraints compromises the principle of establishing a market in which the price of emissions permits is set only by supply and demand. This compromise will mean, they argue, that the emissions target demanded by environmental concerns will not be met, or that the cost of doing so will be higher than is necessary.

Theoretically, this argument is persuasive. However, the experience of such markets suggests that perfectly smooth operations do not always eventuate. There can be undesirable outcomes, the most visible being high price instability that alarms investors if prices crash, or consumers and politicians if prices spike.

A practical example exists in Australia's national electricity market, where a cap is imposed on prices to stop those reaching very high levels for short periods of extreme demand or supply disruptions. In Europe, the carbon price under its emissions trading scheme has been trading at historically low levels for an extended period. There are several reasons for this. However, the European Parliament has responded by proposing market intervention to withdraw permits to rebalance supply and demand. In a similar move, the UK is introducing a floor price to provide greater certainty for investors.

In its report, '[Markets to Reduce Pollution: Cheaper than Expected](#)', Grattan Institute argued in favour of a price floor for the Australian emissions trading scheme. The report argued that the first objective of climate change policy is to reduce greenhouse gas emissions over the long run. An emissions trading scheme is the right policy instrument to form the central plank of this platform.

Over the long haul however, it will not necessarily provide the right signals for investment in technologies to reduce emissions. The market will underprice emissions and therefore will tend to under-invest in low emission actions and technologies. This argument is expanded in a later Grattan Report, '[No easy choices: which way to Australia's energy future?](#)'

The second argument in favour of a price floor rejects the claim that price volatility is a reflection of an efficiently functioning market. In new markets, extreme volatility, or long periods of very low prices may indicate that the market is not actually yet properly established. In this case, the use of price floors can provide the certainty of a minimum investment return for low emission technologies. In summary, price floors have a cost, but they deliver a larger benefit.

### **The recognition of international carbon credits**

The government's second policy decision is to allow international units to be used to meet domestic emissions liabilities in the flexible price period. This will be limited to 50 per cent of annual liabilities until 2020, and the restriction will be reviewed in 2016 by the Climate Change Authority.

This decision also reflects the government's attempt to reach a careful balance. The climate is indifferent to the location of emission reduction on the globe. Therefore, it makes economic sense to be flexible about where emissions reduction occurs. For Australia the ability to use international units reduces the overall cost of meeting its emissions reduction targets. On the other hand, relying entirely on international permits to achieve our targets could be unwise until international agreements and linkages are much more developed, and the integrity of those permits is assured.

The direct consequence of adopting these two policy decisions is that the government must avoid the potential for the purchase of low-cost international units to undermine the price floor. The government's answer to this problem is to impose a surrender charge when the price paid for the international units is below the domestic floor price. The Commonwealth has separately canvassed the specific methodology that should be used to calculate this charge.

Criticism of the surrender charge as being a subsidy from consumers to the finance sector is mischievous, if not self-serving. Of course, those with a liability for emissions in Australia want to minimise the cost of meeting this liability, and the ability to access international units is intended to provide that flexibility. However, once the benefits of a price floor were recognised in the climate change legislation, the need for the surrender charge follows as night follows day.

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