Going global: risks must be managed

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An adequate climate change solution must be global, and Australia should play its part in that solution, writes ***Tony Wood***

Two big questions arise from Climate Change Minister Greg Combet's announcement on Monday that Australia's emissions trading scheme (ETS) would be linked to the European Union's emissions trading scheme.

The first question is whether the linkage creates opportunities for Australia and Australian companies to better participate in the global climate-change response and carbon markets, or whether our system will now be hostage to the vagaries of European politics.

The second question is whether the risk to future budget finances and removal of the floor price are outweighed by the potential cost savings to Australian businesses.

The European ETS is the largest carbon market in the world. Linkage will mean we help create a bigger market. If this bilateral linkage is successful, it is likely to be a forerunner of more of the same.

This is essential for an effective global response to climate change.

Also, international trading will lead to lower costs overall than could be achieved by insulated national or regional markets. On this basis, the big-picture view suggests this is a good outcome.

However, it has been widely reported that the price of emissions permits in the EU has been very low for some time, and certainly below the levels envisaged by the Australian government and many other commentators.

This has been due to a mix of fundamental economics (stressed economies with less industrial output produce fewer emissions), and complex political trade-offs that resulted in an overallocation of free permits and distortions of the market.

Low demand and high supply, not surprisingly, produce low prices.

The European Parliament and European Commission have been grappling with this problem for the past year or so, although the proposed solutions have yet to survive the complex processes of the system. Linkage with the European ETS means the price of emissions permits in Australia will be directly affected by these complex, and inherently political, processes.

The Australian government has been widely criticised for delivering its compensation package for consumers through the tax system such that the cost to its budget is fixed, while the revenue that has to pay for the compensation, the revenue from the sale of emissions permits, will be set by the market.

The $15 a tonne floor price (at about half the price the government forecast) would have limited any potential budget shortfall.

But now that the government has done away with the floor price altogether, the possible budget shortfall could be in the billions of dollars. Whether this hole appears and how deep it might be will be determined by market forces that are out of the control of the Australian government.

Tony Wood, Energy Program Director
T. 03 9035 3867 E. tony.wood@grattan.edu.au

So is the way with markets. Earlier this year, the Grattan Institute, among others, argued the case for a floor price in the Australian ETS, at least in the early stages. Central to this argument is the concern that the Australian price could fall to that of very cheap credits under the international Clean Development Mechanism market.

This price has generally been below the European price and is expected to remain low, and many have questioned whether it is a robust market.

While other elements of the case for a floor price remain, the decision in the announcement yesterday to restrict the use of such credits to 12.5 per cent of the total does substantially address the risk.

An adequate climate change solution must be global, and Australia should play its part in that solution. Arguments that pricing carbon through an ETS should be abandoned simply ignore the evidence that climate change is happening and must be addressed.

Building a network of linked pricing schemes can be a critical part of the solution. The government's move in this direction carries risks to be managed, but is heading in the right direction.

Tony Wood is the Energy Program Director at Grattan Institute

www.grattan.edu.au

Tony Wood, Energy Program Director
T. 03 9035 3867 E. tony.wood@grattan.edu.au