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Carbon price is about low-cost emissions reduction, not closing power plants

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*If closing brown coal power plants is part of the lowest cost mix of emissions reduction opportunities, then they will close without additional payment from the government, writes **Tony Wood***

This week the Australian Government announced that the “payment for closure” element of the Clean Energy Future package would not proceed. The decision has saved taxpayers a multi-billion dollar outlay without compromising the environmental or financial objectives of the overall policy. One might wonder why the decision created the level of criticism that we have seen.

At one level, the facts are straightforward. The government had said it was prepared to pay directly in cash to cause closure of around 2000MW of power plant capacity from the most polluting power plants (ie brown coal). The caveat was that this payment had to represent value for money. After many months of negotiations and in light of current circumstances, the government has decided that the payments sought by the companies to close their plants would not meet this criterion, and so there is no deal. There has been no change in the target or other central elements of the emissions trading scheme (ETS), and therefore no change to the environmental outcome that the policy will deliver.

The ETS is designed to deliver an emissions reduction target at lowest cost. If closing brown coal power plants is part of the lowest cost mix of emissions reduction opportunities, then they will close without additional payment from the government. If there is a mix of emissions reduction actions that meets the target at lower cost without closure of brown coal plants, then that is what the ETS will deliver. This is the power of, and rationale for, introducing a market mechanism.

A payment to close any specific capacity will only increase the cost of meeting the target, in the same way that payment to add any specific capacity, such as renewable energy, does the same thing. There may be other reasons for taking one of these actions, but reducing emissions at lower cost is not one of them.

There seem to be at least two arguments behind criticism of this week’s decision. The first argument is that the ETS was supposed to cause closure of the dirtiest coal power plants first, but the emissions price would be too low for this to happen. Therefore, payment for closure was necessary to compensate for the low price and achieve the objective.

This interpretation can feel seductively sensible. However, it is wrong at the most basic level, as it requires re-inventing the purpose of climate change policy delivered via an ETS. The objective is to reduce emissions across the covered sectors at the lowest cost: closing brown coal power plants may not meet that objective. If closing brown coal plants, whatever their emissions, had been the policy objective, then a different policy tool should have been selected. Allowing these plants to continue to run for some time may feel uncomfortable, but it is the right answer for the right reason.

The second argument is that the government has gone back on a key element of the deal and compromises that the Clean Energy Future policy package represented. The published material is certainly clear that it was an option the government was prepared to consider and apparently sought to deliver. However, it would hardly be sound policy for this to have represented a blank cheque from Australian taxpayers to the power companies, and the “value for money” condition was always the

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

safety valve. Critics have so far failed to argue convincingly for closure at any price, and the government is very clear that this was never part of the deal. One could argue that payment for closure was a fundamentally bad idea that was always going to fail, but fail it has on the predefined conditions in the announced policy.

It is possible that payment for closure would have meant more physical emissions reduction within Australia and the purchase of fewer international permits. If so, then this week's decision will lead to the opposite outcome. Treasury modelling of the ETS impacts does not shed light on this question, since it was completed without including the payment for closure proposal.

Deciding which outcome is preferable depends on whether one is comfortable with an outcome that meets environmental goals at lowest cost or whether one is driven to more particular outcome, namely shutting down coal-fired power stations, as the primary objective.

Given the debate over last week's decision to link Australia's ETS with the European scheme, and this week decision on payment for closure, it will be hardly surprising if next week's debate shifts to the $23 per tonne initial fixed price or the compensation payments being made to generators. What fun!

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