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Why the ERF safeguard mechanism fails to balance environment and economic priorities

Grattan Institute submission to the Department of the Environment's Consultation paper, "Emissions Reduction Fund: Safeguard mechanism"

Emissions Reduction Fund: Safeguard mechanism

Consultation Paper: Submission from Tony Wood, Energy Program Director, Grattan Institute

1 Summary points

- The safeguard mechanism described in the Consultation Paper will not achieve its stated objective of ensuring that emissions reductions purchased through the Emissions Reduction Fund are not displaced by a significant rise in emissions elsewhere in the economy. This is because it is not designed to achieve this goal. Instead, the mechanism is designed to allow emissions baselines to be adjusted to accommodate most foreseeable activities that could give rise to an increase in emissions. As a result, its impact on reducing emissions is likely to be zero.
- The safeguard mechanism sacrifices environmental integrity in order to avoid imposing immediate cost impacts on emitting facilities. In the short term this is disappointing; in the long term it is unacceptable. Cost avoidance today is likely to lead to greater costs in the future. Detailed design elements should be consistent with future moves to create a safeguard mechanism that genuinely contributes to meeting Australia's climate change targets.
- In an efficient safeguard mechanism, any facility covered by the mechanism would be able to create carbon offsets from voluntary actions that reduce emissions below an established baseline. Such offsets could then be cost-effectively used by other facilities to "net off" emissions that exceed baselines.
- If a civic penalty is used as the final sanction to address an emissions exceedance it should be at a level that provides a real deterrence to significant emissions increases.
- A sector-specific mechanism should be applied to electricity. One approach could be to adapt the approach to baselines and emissions applied by the New South Wales Government in its Greenhouse Gas Abatement Scheme. Alternatively, the Renewable Energy Target could be expanded to become a Clean Energy Target, set at a level that reflects the Government's overall emissions reduction target.
- Gas combustion contributes significantly to Australia's greenhouse gas emissions. It could be included in the safeguard mechanism by placing emissions responsibility on gas producers or retailers.

2 Introduction

This submission from the Grattan Institute responds to the Department of the Environment's Consultation Paper on the safeguard mechanism linked to the Emissions Reduction fund under the Government's Direct Action Plan.

Grattan Institute is an independent think-tank focused on Australian domestic public policy. We aim to improve policy outcomes by engaging with both decision-makers and the community.

We understand that the Consultation Paper is seeking submissions on a range of specific implementation issues, with a number of important policy decisions having already been made. Based on the Consultation Paper and discussions to date, we believe that the safeguard mechanism as described in the Consultation paper will not achieve its fundamental purpose, which is "to ensure that emissions reductions purchased through the Emissions Reduction Fund are not displaced by a significant rise in emissions elsewhere in the economy". Rather, it seems to be designed to protect only against what might be described as rogue operators who breach their specific baseline.

The questions raised in the Consultation Paper regarding the process for setting and revising baselines illustrate the difficulties inherent to this approach to constraining emissions increases. We conclude that the safeguard mechanism as described will also breach one of the three design principles of the development of the Emissions Reduction Fund, namely streamlined administration.

We recognise that the safeguard mechanism may be modified in the future, and we will respond to any such modifications as they emerge. This submission focuses only on the design elements and implementation issues as they are raised in the Consultation Paper.

3 Implementation options

3.1 Coverage

Electricity generation is a significant source of Australia's emissions. Its inclusion in the Direct Action plan is essential and it is appropriate to place responsibility for the emissions from electricity production on the generators. The combustion of gas is also a significant source of emissions. While emissions from electricity generation occur largely at centralised, large facilities, emissions from gas combustion occur across many Australian businesses and homes. This does not mean that emissions from gas combustion should be excluded from the

safeguard mechanism. An effective approach could be to make producers or retailers of natural gas responsible for these emissions.

3.2 Establishing baselines

The process for establishing baselines exposes one of the difficulties the design of the safeguard mechanism faces in order to achieve its purpose. A choice based on the historical emissions of facilities is probably unavoidable, but will lead to considerable debate and potential gaming. More importantly, the decision, described in the Emissions Reduction Fund White Paper to allow baselines to be adjusted to accommodate new investments leads strongly to the conclusion that the safeguard mechanism, as designed, cannot fulfil its stated purpose.

If the goal is merely to accommodate variability in emissions from business without forcing them to pay a penalty, a more efficient approach would be simply to set the baseline using the highest level of emissions over an historical period.

3.3 Changes at facilities (boundaries, expansion or new investment)

The need to set baselines that need to be revised whenever there are significant changes in emissions levels at a facility exposes the inherent difficulty with the baseline approach. Processes to manage these changes need to be established so that they can be easily modified if a system of tightening or declining baselines were to be established at a future date, as part of an effective safeguard mechanism. For example, the use of emissions intensity against some acceptably high standard (best of class, industry best practice, and so on) is likely to be such an approach.

The Consultation Paper indicates that the limited ability of a facility to control emissions involved in extractive industries may be a factor in allowing baseline adjustments. It fails to recognise that the emissions intensity from a specific natural resource, even when industry best practices are applied, may be so high that the facility should not have been approved in the first place, let alone had a baseline set for it. This serious omission should be explicitly addressed.

3.4 Defining best practice

It is not surprising that businesses have sought recognition of individual facility circumstances in setting baselines. In attempting to address

this argument, the Consultation Paper exposes another inherent challenge. It suggests that facilities that use different processes, with different emissions intensity to produce the same product, should be treated differently. Yet at the same time it seeks to treat the electricity sector as a special case with a sector-specific baseline. There is a case for applying the same approach to any sector that produces a homogeneous commodity. We would not set different speed limits for a Ferrari and a Corolla based on their individual vehicle characteristics.

The Consultation Paper seeks to cover a very wide set of possible circumstances that could apply to existing, expanding and new facilities. A specific example is the suggestion that significant expansion in production be defined as 20 per cent. Such an arbitrary figure is likely to create more problems than it solves, and we suggest that application of a consistent or improved emissions intensity test would avoid the problem.

3.5 Emissions management

The Consultation Paper recognises the need to find a balance between environmental integrity and commercial costs, but it is silent on how such a balance might be achieved. For example, it argues that deterring emissions increases above established baselines should be achieved in a way that “does not impose unnecessary costs on Australian businesses”. Yet it provides no definition of what the Government means by “unnecessary” in this context. Without such definition, it is unclear how the Government will design its deterrence mechanism. The content of the Consultation Paper strongly suggests that the Government will place greater weight on avoiding costs than on protecting environmental integrity.

The Consultation Paper seems to have accepted the argument from businesses for flexibility in managing their emissions. While it may be a good idea to have a degree of flexibility in implementing deterrence measures in the early stages of the safeguard mechanism, in the long run this is like a driver asking a traffic policeman for flexibility to help manage her speeding.

3.6 Net emissions and carbon offsets

The Consultation Paper recognises the benefit of using carbon offsets to net off emissions when a baseline might be exceeded. These could include Australian Carbon Credit Units (ACCUs) created for businesses that win emissions contracts under the Emissions Reduction Fund (ERF). If this is desirable, and given the limited funding available under the ERF, similar flexibility could allow any facility to create ACCUs from voluntary actions that reduce emissions below an established baseline even when the action does not have a contract under

the ERF.

3.7 Enforcement options

The Consultation Paper refers to the decision to apply a civic penalty as the final sanction to address an emissions exceedance. Yet it provides no detail as to how the level and maximum amount will be set in the regulations. At the very least, a level that provides a real deterrence to significant exceedance is essential. A multi-level scale may be appropriate, as occurs in other areas where civic penalties are the final sanctions.

3.8 The electricity sector

The Consultation Paper identifies specific challenges that arise in applying the safeguard mechanism to electricity. The sector is unique. The electricity that reaches consumers is the result of multiple production processes with differing emission intensities. There is also great uncertainty regarding the cost of fossil fuel inputs and the levels of future energy demand and its impact on emissions. The existence of the Renewable Energy Target (RET) complicates the picture by directly influencing emissions from the sector. It seems that the Government wants to set baselines for the sector in order to manage growth in output and the interaction with the RET without baselines being exceeded, at least until 2020. Any solution to this challenge through the way baselines are set seems to lead to high uncertainty or administrative complexity, or both.

We suggest that a sector-specific solution be considered. The safeguard mechanism's approach to baselines could be varied along the lines of the baseline and credit approach of the New South Wales Greenhouse Gas Abatement Scheme. Alternatively, the RET could be expanded to become a Clean Energy Target, with the target for the expanded RET established to reflect the Government's overall emissions reduction target.

For any queries, please contact:

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