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Australia's emissions reduction targets: predictable flexibility for changing circumstances.

Grattan Institute response to the Department of Environment and Energy's paper: National Energy Guarantee, Draft Detailed Design for Consultation, Commonwealth Elements, June 2018

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Summary points

- The design of the emissions obligation of the National Energy Guarantee (the Guarantee) should ensure that the framework can respond without fundamental re-design to future developments such as changes to Australia's target, the adoption of tradable certificates and expansion beyond the electricity sector.

- Australia's absolute emissions reduction target should be set as a 10-year trajectory for the period 2021-2030 and reviewed to maintain consistency with Australia's economy-wide targets as currently committed under the Paris Agreement. This review should occur at least every five years, beginning in 2020 for the period 2026-2030. A three-year review cycle should be considered.

- The emissions intensity targets for the Guarantee should be calculated by directly linking the National Electricity Law with the national absolute target using the most recent forecast of electricity demand from the Australian Energy Market Operator (AEMO) as proposed in the Consultation Paper. The emissions intensity targets should be reviewed annually based on the annual updated forecast.

- The carryover of exemption from the Renewable Energy Target (RET) to the Guarantee for emissions-intensive trade-exposed (EITE) activities should be revisited, considering the economic modelling of electricity price impacts as undertaken for the Energy Security Board. At the least, a carbon leakage test should be applied to any exemption.

- Application of domestic emissions offsets against the liability should be allowed, but limited while Australia's emissions reduction obligation applies only to the electricity sector. The use of offsets should be expanded to include international offsets as the integrity of these is established.

Setting and reviewing the electricity emissions target

Emissions targets need to be set as part of the Guarantee and delivery of a long-awaited, credible emissions reduction pathway for the electricity sector. If the Guarantee is to be durable beyond the current political cycle, it should provide a framework that can respond to plausible future developments without major re-design. These issues are clear in themselves, but very unclear as to how or when they will emerge:

- Australia's emissions reductions targets will need to be revised regardless of the outcome of international or domestic negotiations or elections.
- Although precluded from the design of the Guarantee today, some form of tradable permits or certificates is likely to emerge to support an efficient market for emissions reductions.
- A linkage between emissions reductions in the electricity sector and the rest of the economy will emerge to deliver the lowest cost achievement of the economy-wide targets.

The design of the Guarantee should allow for, or at least not preclude, modifications or expansion to incorporate these developments.

The Commonwealth Government (the Government) has set an electricity sector emissions target of a 26 per cent reduction on 2005 levels by 2030. The remainder of this submissions works within that constraint.

a) Setting the target

The Department of Prime Minister and Cabinet's UNFCCC Report of 2015 makes it clear that "an emissions budget approach should be used – that is, achievement of our target should be measured in terms of emissions over the period 2021-30, and not simply our emissions at a point in time in 2030". This is taken to mean that the Government will set the initial ten years of targets.

Much has been written elsewhere on the trajectory of emissions reduction targets. We recommend that this be a straight line from 2021 to 2030, with allowances for banking of over-compliance being allowed in the detailed design of the emissions reduction obligation of the Guarantee.

The absolute level of emissions targets is a matter for, and should be set by, the Government. Translating the absolute emissions reductions to a trajectory of emissions intensity targets emerges from the design of the National Energy Guarantee (the Guarantee) and is a matter for the COAG Energy Council. We recommend that the implementation of the Guarantee through the National Electricity Law includes a simple direct link to the Government's absolute targets and AEMO's forecast for demand.

b) Reviewing/adjusting the target

There are two parameters that determine the emissions intensity reduction targets. The first is the absolute emissions reduction trajectory and the second is the forecast of electricity demand.

The structure and process of the Paris Agreement makes it highly likely that Australia's target will be revised in coming years. Any revision will presumably involve a decision taken by the Government at that time, as was the existing target. It is therefore recommended that the legislation includes a clear process that adjusts the targets consistent with any adjustment to Australia's national emissions reduction target.

It makes sense for an initial 10-year trajectory to be established consistent with Australia's current international commitment. We recommend that the trajectory be reviewed more frequently than proposed in the Consultation paper. First, we recommend that a review of the 2026-2030 absolute targets should be undertaken by 2020, consistent with the proposed approach for 2031-2035. It may be that that review serves only to re-commit the previously established target. A five-yearly review seems longer than prudent in a rapidly changing environment, although a level of certainty for investment is required. We recommend that a 3-year review cycle should be considered as a more practical approach.

We take a different view on the emissions intensity target that will drive the emissions reduction obligation of the Guarantee. The Government's target for Australia is an absolute target and represents consideration of a range of environmental, political and economic factors. The emissions intensity trajectory combines this target with a forecast of electricity demand. That forecast will be wrong, so that the absolute target will be over-, or under-achieved. A similar challenge arose with the RET. Converting a relative target (20 per cent renewables by 2020) to an absolute target in the name of certainty delivered the opposite outcome.

We recommend that the 10-year emissions intensity trajectory be set and automatically revised annually based on the annual Electricity Statement of Opportunities as published by the Australian Energy Market Operator. The Consultation suggests this would create too much uncertainty. In our view it would do the opposite. A clear process would be eminently manageable by the industry and would ensure that national emissions reduction target is reached.

Exemption for emissions-intensive trade-exposed activities

The Government's RET legislation provides exemption for EITE activities[1]. The Consultation Paper proposes that this exemption be extended to the Guarantee. This exemption means that the emissions obligation for such activities under the Guarantee will have to be carried by other activities, effectively a significant cross-subsidy. Imposing such a cross-subsidy requires at least some pause. We see two fundamental problems with this extension.

First, the underlying rationale provided in the Consultation Paper for the exemption "is preserving the international competitiveness of Australian businesses carrying out emissions-intensive activities". This would seem challengeable since the economic modelling underpinning the case for the Guarantee shows that electricity prices under the Guarantee will be lower than otherwise. On that basis the Guarantee does not represent any threat to the competitiveness of Australian businesses, in fact the opposite.

Second, many international competitors face similar obligations. There is only a genuine case to be made for exempting EITE activities when international competitors do not face any similar obligation and its imposition in Australia would lead to a transfer of that activity to another country with adverse economic impact on Australia and a neutral or even negative environmental impact ("carbon leakage"). The original exemption under the RET failed to make this differentiation.

We recommend that the rationale for extending the RET exemption to EITE activities be fundamentally reviewed to address these two concerns. In our view the exemption should not be extended to the Guarantee. If it is, a carbon leakage test should be applied as a more robust eligibility criterion than currently proposed.

[1] "these businesses are competing in an international setting where their competitors do not face a similar impost."
http://climatechangeauthority.gov.au/node/60

External offsets

In principle, we support the use of credible external offsets, domestic or international, as a flexible compliance option under emissions reduction policies generally, and under the Guarantee specifically. Their use would also meet all three of the design principles listed in the Consultation Paper:

- Ensuring affordability: their use would lower the cost of the Guarantee since they would only be used if they provided a lower cost alternative to the liable parties.
- Ensuring efficient investment: they would promote efficient investment in a wider range of activities than would occur from within the electricity sector.
- Promoting competition: they would promote competition between a wider range of activities.

The establishment of the Guarantee will provide a credible forward market in emissions reduction activities. Allowing market participants to choose between emissions reduction actions within the electricity sector or from offsets created outside the sector will deliver a lower cost for the same environmental outcome than would be delivered if offsets were excluded.

We acknowledge two caveats to this argument that would otherwise lead us to recommend the unlimited use of credible offsets.

The first is that the Guarantee covers only about one-third of Australia's emissions. There may be an argument that allowing the electricity sector sole access to these offsets while other sectors are not covered by any emissions reduction obligation may be an inefficient use of their value. This would be emphasised if, as is widely considered, the electricity sector has amongst the lowest-cost opportunities for emissions reductions.

The second caveat recognises that some sources of international offsets may not carry the level of environmental credibility that Australia would require. There is considerable uncertainty around the international carbon accounting rules that will apply after 2020 and restrictions on their application to domestic targets may emerge. A prudent Australian response would be to avoid overly committing to their unrestricted use or denying their application completely.

Therefore, we recommend:

1. Domestic offsets (Australian Carbon Credits Units) should be allowed against the emissions liability of the Guarantee. A limit should be imposed as a percentage of the liability, say 10-20 per cent.
2. This limit should be removed as and when Australia's emissions reduction policy extends beyond the electricity sector.
3. International offsets should be progressively allowed as the Government identifies credible sources of such offsets. This process is described in the Consultation Paper. A limit, say 10-20 per cent, should also be imposed to

ensure that Australia has flexibility if international climate change rules impose future restrictions on the use of international offsets.

A benefit of this approach is that the Emissions Reduction Fund, currently an on-budget item for the Government, would become self-funding. The experience of the Fund to date is that it has delivered low cost emissions reductions, i.e., around $12 per tonne of CO_2-e.

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