Investor Group on Climate Change

IGCC statement on areas of possible amendment to the CPRS

Wednesday 21st October

The Investor Group on Climate Change (IGCC) represents institutional investors with funds under management of approximately $500 billion, and others in the investment community exposed to the impact of climate change. We are long-term investors on behalf of Australian superannuants and other investors and are part owners of companies in all sectors of the economy, in all asset classes.

As major investors in the Australian economy, we recognise that in time, the Australian economy must significantly reduce its emissions, and adapt to climate change, if the economy is to continue to be a sound investment for institutional investors. We support policies that allow incorporation of a carbon price in the economy, so companies and individuals can consider the costs and opportunities, of addressing climate change in their decisions.

This statement outlines principles under which IGCC has considered the operation of the CPRS and currently proposed amendments, and discusses specific areas of possible amendment to the CPRS.

Principles

Early commencement of emissions trading lowers the overall cost of transition

An early start on a low-emissions transition is the lower cost path for the economy and our investments. A delayed start and consequently faster reduction rates to meet agreed emissions reduction targets increases the chance of a more volatile economic and investment transition. As long-term investors across all sectors of the economy, IGCC members are concerned to ensure as smooth an economic and investment transition to a low-carbon economy as possible.

Broad sector coverage shares the cost of economic transition

Investors are concerned with the distribution of costs within the economy as well as total cost to the economy. Broad sector coverage of an emissions trading scheme is necessary to ensure that no sector must carry the burden for emissions reduction on behalf of other sectors in the economy. Broad sector coverage also provides the greatest opportunity for lowest cost domestic abatement.

- IGCC recognises that some sectors and companies have limited potential to fully pass emissions costs though, especially if companies operate in international markets where no comparable price on carbon is in place. However, trade exposure is not a reason for a sector to be fully protected from the abatement costs faced by the economy as a whole. The higher the levels of transitional assistance or compensation provided to certain sectors, the higher the total costs (i.e. abatement and adjustment costs) transferred to other sectors of the economy, leading to inefficient wealth transfer.

Transitional assistance should be provided to achieve the environmental outcome of lower emissions

Transitional assistance should be provided to minimise the likely transfer of **existing** industry or operations overseas (the so called 'carbon leakage' effect) and to provide a degree of long-term certainty on the level of transitional assistance to enable long-term investment, including investment in abatement. Therefore, IGCC members believe:

- EITE assistance should provide protection for certain activities only in the event that trading partners do not accept comparable emissions reduction costs for those activities;
- Transitional arrangements should not remove the incentive for industries to reduce their emissions or eliminate emissions intensive activities;
- Non trade-exposed activities should not receive compensation for loss of future profits. If financial assistance is provided to non trade-exposed sectors it should be provided to support security of energy supply.

To be effective as a market mechanism, the carbon price must respond to market forces

Price caps or limitations on carbon price cost pass through undermine operation of the market and should ultimately be removed.

IGCC perspective on the areas of possible amendment to the CPRS

The CPRS is fundamentally acceptable as a framework to enable a reduction in CO2e emissions and its passage through the parliament should not be delayed. From an investor perspective this is because the CPRS: a) provides a degree of investment certainty; and b) fosters least cost abatement. While IGCC retains concerns about distribution of abatement costs and wealth transfer through the economy from the CPRS, greater investment certainty and a mechanism to foster least cost abatement are higher priorities for investors.

IGCC considers that the CPRS provides an emissions trading framework that is flexible enough to accommodate the outcome of future international negotiations, including those at Copenhagen. IGCC supports an Australian Government negotiating position seeking an ambitious agreement in Copenhagen (a 450ppm CO2e stabilization target for 2050) therefore requiring a 25% emissions target by 2020 in Australia. Even without international agreement in the short-term, it is important that there is a domestic carbon price mechanism in place to commence transition to a less emissions intensive Australian economy. A CPRS with a 5% reduction target and current transitional arrangements under the CPRS is consistent with this objective.

Fugitive coal emissions should be included in the CPRS and transitional assistance limited to gassy mines

Fugitive emissions from coal should be included in the CPRS due to economic efficiencies from a scheme with broad coverage. IGCC notes that Australia's domestic coal sector includes some mines that are high emitters of methane gases and many that are not. It is particularly important that companies operating existing and new mines incorporate the cost of fugitive emissions in investment decisions, particularly when considering alternatives, e.g. investment in a non-gassy mine verses a gassy mine or alternative mine operations which may have different emission abatement options. This is particularly important given the significant percentage of national emissions fugitive coal emissions represent (4.4% of 2007 emissions), the potential for relatively low cost emission abatement and the expected significant growth of the Australian coal sector. Excluding coal mine fugitive emissions is at odds with the need to reduce domestic emissions and especially so in the context of an international agreement.

In the event that any additional financial assistance is provided to coal mining companies it should be focused only on abatement of fugitive emissions and for development of fugitive emissions control technologies. IGCC is aware of projects in Australia that are trialling emissions control technologies from emissions intensive coal mines but notes that without a modest price on carbon, there is likely to be insufficient financial incentive to resolve these projects. Some short-term transitional assistance (1-3 years) maybe required to enable the effective implementation of emission abatement options, including technology for methane in mine ventilation gases, for the most gassy coal mines.

Impacts on coal mining

IGCC understands that some mines (and regions) in Australia may be impacted as a result of the flow-on effect of including the cost of coal emissions. This would be a result of the effective operation of the market mechanism (CPRS) to reduce emissions and is, from an economic efficiency viewpoint, an expected outcome. Investors consider that it falls to governments to provide restructuring assistance to regions and employees in the event that mines and regions are economically impacted. The adjustment within the economy, and the coal industry in particular, should not be confused with the impact of considering fugitive emission within the CPRS,

Compensation for coal-fired energy generation

IGCC recognises that a small number of institutional investors may suffer financial loss from investments in coal-fired energy generation. Despite this, as portfolio investors we consider that compensating generators sets a precedent in the Government, and ultimately other sectors in the economy in which we invest in, picking up the costs for a sector not effectively considering investment risk. Such a precedent for compensation will fundamentally challenge the risk/return equation important for the appropriate and efficient investment of capital within the sector and the Australian economy.

IGCC does not believe that extending current compensation to coal-fired electricity generators will ensure investment in emissions abatement. Ultimately emissions abatement should be the objective of any compensation beyond that required to ensure the operation of coal-fired generation. Beyond this security of energy supply for communities must be balanced with the economic need to retire the most emissions intensive coal fired energy generation assets. Furthermore, IGCC considers:

- Given their position in the merit order of generators, existing generators will have an incentive to maximise potential for fixed cost recovery through energy supply;
- The electricity market functions on the basis that the price in the market will reflect demand and any scarcity of generation capacity;
- Investors, comprising owners of existing assets as well as new entrants, will not desert the energy market and opportunities to invest in new energy generation assets if clear policies such as the expanded Renewable Energy Target and a functional emissions trading scheme are in place;
- Given the sensitivity of the assumptions used, it is difficult to assess the extent of value loss beyond the medium term;

If the Government chooses to compensate investors for lost asset value in the coal fired generation sector, this should be considered relative to the benefits of allocating funds to other emissions abatement projects or supporting the development of less emissions intensive energy sources. We estimate that extending compensation by approximately $6.5 bn for coal fired generators over 10 years comes at a cost of abating approximately 32.5 million tonnes of CO2 per year (@$20/tonne CO2-e). We also note that underwriting the operation of coal fired generators for 15 years is seemingly at odds with the need to reduce emissions from this sector over time, unless substantial emissions abatement can also be achieved.

Carbon cost pass through to retail energy prices

IGCC considers that a full review of retail electricity pricing arrangements is necessary to ensure that limitations on cost pass through are reduced or eliminated. For the pricing effect of the CPRS to influence the market demand for energy, it is important restrictions on retail pricing do not counteract the aims of the CPRS.

Emissions Intensive Trade Exposed sector compensation

Emissions Intensive Trade Exposed (EITE) sector transitional assistance is intended only to assist companies in the event that comparable international efforts on emissions reductions are not forthcoming. While the timing for resolution of current international negotiations is uncertain, investors are optimistic about resolution of a new global agreement in the short to medium term.

IGCC considers that companies should be preparing for imposition of a carbon price, expecting that price to rise over time and preparing to receive reduced assistance from the impact of that price over time. Investors prefer a steady rate of decay in assistance over time to the step change proposed by the Opposition.

While the specific changes the Opposition proposes to the EITI assistance have not been detailed, the IGCC believes there may be a risk of windfall gains to EITE's if an emissions intensity allocation is extended to electricity generators, such that electricity price increases are dampened and the quantum of assistance to EITEs for Scope 2 emissions, currently proposed at 1 tonne /MW-hr, is maintained. While investors may gain in the short term from such an outcome, windfall gains are clearly an unintended consequence of the increased levels of compensation to EITE's and modified compensation arrangements to energy generators. The IGCC would expect further clarification from the Opposition on how the EITE transitional assistance for Scope 2 emissions will be linked to the emission intensity allocation given to generators.

On the inclusion of primary food processing such as meat and dairy in the EITE assistance, IGCC questions how the emissions intensity levels of these activities can be established to demonstrate that inclusion in transitional assistance arrangements is warranted.

Publishing of draft regulations on EITE coverage

IGCC considers resolution and publishing of draft regulations for Emissions Intensive Trade Exposed (EITE) activity coverage to be a matter of urgency. It is important that investors are able to assess the financial impact of the CPRS on their investments and known activity transitional arrangements are required to achieve this. We urge the Government to publish the draft regulations as soon as possible to minimise policy related investment uncertainty.

Including agriculture in the CPRS

IGCC contends that if a market based price on carbon is to provide efficient emissions reductions across the economy, the CPRS must have the widest sector coverage possible.[1] If any sector is excluded, the cost of emissions abatement will fall to other sectors of the economy and increase the cost burden for abatement on those sectors.

As the agriculture sector accounts for approximately 17% of Australia's emissions it is important that the sector take <u>both</u> some of the burden of meeting national emissions reduction targets and have a financial incentive to develop and implement carbon abatement opportunities.

Given the technical issues around measurement of emissions from the agriculture sector it is reasonable to delay inclusion of the sector in the CPRS until appropriate techniques to estimate emissions can be

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[1] IGCC considers that fuel price increases resulting from the CPRS should not be offset with a reduction in fuel excise. Reducing fuel excise eliminates the price effect on carbon emissions in the transport sector.

resolved. Delaying the inclusion of agriculture indefinitely or for a fixed time period, for example until 2020, is likely to delay resolution of the technical emissions measurement issues. IGCC considers that an expectation that agricultural activities will be included in the scheme as soon as possible should be the operating principle following in reducing agricultural emissions.

IGCC is open to development of alternative emissions reductions steps in the Agriculture sector before emissions are included in the CPRS. For example IGCC supports the importing and potential generation of "credits" from soil carbon sequestration if and when there is global agreement on inclusion of these activities. However IGCC does not support provision of credits for sequestering carbon in soil until emissions from activities related to land management are also included under the CPRS.