



## Investor Group on Climate Change Australia/New Zealand (IGCC)

10 March 2006

Mr James White  
National Emissions Trading Taskforce  
C/- NSW Greenhouse Office  
Level 11, Bligh House  
4-6 Bligh St  
Sydney NSW 2001

Dear Mr White

The Investor Group on Climate Change (IGCC) (Australia/NZ) thanks the Inter-jurisdictional Emissions Trading Working Group for the opportunity to provide comment on a National Emissions Trading Scheme and specifically the "Background Paper for Stakeholder Consultation" (attached).

The IGCC represents Australian investors, with total funds under management of over **\$177 billion**, and others in the investment community interested in the impact of climate change on investments. More information on the IGCC can be found at [www.igcc.org.au](http://www.igcc.org.au).

The IGCC aims to ensure that the risks and opportunities associated with climate change are incorporated into investment decisions for the ultimate benefit of individual investors through:

- Raising awareness of the potential impacts, both positive and negative, resulting from climate change to the investment industry, corporate, government and community sectors;
- Encouraging best practice approaches to facilitate the inclusion of the impacts of climate change into investment analysis by the investment industry; and
- Providing information to assist the investment industry to understand and incorporate climate change into the investment decision.

### **What is IGCC's Interest in the Stakeholder Consultation Paper?**

The IGCC represents a range of interests in the investment community, including superannuation funds, large multi-asset managers and single asset managers. Therefore, the members of the IGCC are investors in both publicly listed and private companies, across all sectors of the Australian economy and internationally. The objective of the individual members of the IGCC is to obtain, or provide advice to others, on gaining acceptable risk adjusted returns for their investments. The size and mandate of the members means the focus is both on short-term and long-term returns.

The IGCC believes climate change is likely to bring significant global economic, social and environmental risks. As a result significant action is required to reduce current and future emissions so as to minimise the potential adverse impacts. For investors that invest across all sectors of the economy, climate change risks cannot be easily mitigated through diversification, as all sectors and economies will be impacted. Therefore, climate change risks have the potential to significantly impact the mid to long-term returns of the investors.

The IGCC believes that the introduction of a national emissions trading scheme as one of a number of appropriate government policy mechanisms needed to address the economic, environmental and social risks of climate change. As IGCC members invest across the economy, the IGCC is concerned with the impact on both specific sectors and the broader Australian economy in the short-term and how the Australian economy adjusts to the new reality of a greenhouse gas emission constraint in the mid to long term. The IGCC members believe that the adjustments to the Australian, and other economies, may be significant and, while there may be political



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uncertainty at the international level, it is in the long-term interest of the broader Australian economy and investors that actions are undertaken with certainty sooner rather than later so a smoother transition can be made to the economy.

IGCC members are acutely aware that the cost of addressing climate change will be paid by companies in which we invest or potential investors and therefore the total cost of the ETS should be minimised. In addition, the IGCC are concerned that only addressing the concerns of one sector merely transfers the cost to another. From an economic perspective, the underlying principle should therefore be that liability for greenhouse gas emissions is with the emitter and that the market addresses the distribution of the costs through the economy. One of the key objectives for government in developing the ETS is to reduce the risk of investing in emission abatement, which will have the benefit of decreasing the cost of abatement and the cost of the ETS for all sectors of the economy.

Attached is more detailed discussion of the IGCC's views on the specific issues raised in the Stakeholder Consultation paper.

The IGCC would be happy to discuss further the issues raised in this submission and please do not hesitate to contact Ms Joanne Saleeba, IGCC Secretariat on (03) 9415 7071, 0422 101 715 or by email [secretariat@igcc.org.au](mailto:secretariat@igcc.org.au).

Yours sincerely

Bob Welsh  
Chair of the Investor Group on Climate Change



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### **Proposition 1: That a cap and trade approach be used as the basis for scheme design**

The IGCC generally supports the use of a cap and trade approach as the basis of the scheme.

The IGCC invests in companies that have direct and indirect exposure to the European Union Emissions Trading Scheme. The IGCC believes it would be in the interest of these companies and for the Australian economy, in general, for any Australian scheme to be compatible with the EU ETS, in as much as the commodity or commodities created by the market, i.e. permits (or allowances) and credits, need to be fungible between the two schemes. This does not mean that the Australian scheme needs to be the same as the EU scheme, as the EU ETS has demonstrated some lessons that can be used in the development of an Australian ETS.

Six notable lessons are:

1. Long-term emission reduction targets and transition targets are required to reduce the level of risk for investments in energy and greenhouse gas intensive industries;
2. Lump sum allocation of permits, e.g. via grandfathering, can lead to opportunity cost pricing by sectors such as the electricity generating sector;
3. The step change in energy costs as a result of either auctioning or opportunity cost pricing can have a significant unnecessary impact on the economy;
4. The design of the ETS should consider the means to transition the economy into the new reality of costing greenhouse gas emissions, as well as the environmental objective of reducing emissions;
5. All industrial sectors should be covered by the trading scheme; and
6. Potential inclusion of aviation into the trading scheme.

Any Australian scheme needs to also be flexible enough to accommodate/adjust to any other international schemes that come on line.

### **Proposition 2: That the scheme be national and sector based**

The IGCC believes that national consistency is an appropriate goal for the scheme. The IGCC also believes that a diversified portfolio of electricity should be facilitated.

The IGCC agrees with the institutions identified in the AFMA submission as being required for the operation of the ETS. The IGCC would also like to emphasise the benefits of using existing structures or regulatory/oversight bodies where possible to minimise the administrative costs of the scheme.

In addition, the IGCC believes that the current NSW GGAS and Queensland 13% Gas Scheme should be replaced over time by the ETS. However, the IGCC believe there is value in maintaining and expanding the MRET scheme as a means of developing the sector and facilitating a diversified portfolio of electricity generation in Australia.

### **Proposition 3: That in setting the cap, consideration be given to the overall national emissions abatement target and how abatement responsibility between sectors covered by the scheme and those outside the scheme.**

The IGCC believe that it is critical for investor certainty that medium to long term targets are set. Given lead time for developments and the economic life of major generation and energy intensive investments, an emissions target for 2030 is required, with an indicative target for 2050. The target for 2050 can be made a firmer commitment in the next 10-15 years based on the emergence of firmer international agreement. Along with these targets, how the emissions cap changes with time needs to be addressed and then communicated.

In addition, for the ETS to be a meaningful policy instrument, it is critical that the emissions cap reflects the overall national emissions cap. One way of achieving this is to ensure that a high percentage of the emitters are covered by the ETS.

There appears to be adequate scientific evidence that substantial greenhouse gas reductions targets are required (50-60% by 2050) if Australia is to contribute to the currently required global reduction in greenhouse gas emissions. A number of potential pathways are available to achieve this goal. Some of the issues to be considered in developing the most appropriate pathway include:



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- economic life of existing and potential investments;
- likely costs (\$/tonnes CO<sub>2</sub>-e abated) of potential abatement actions; and
- potential timing and cost of new technologies.

The IGCC agrees that this is an area requiring further consideration and assessment by the working group.

A significant regulatory issue for investors is that there is consistency in the framework of the ETS over time. Changes in government policy can generally be accommodated by the market if sufficient notice has been given of the changes, with the amount of notice depending on the magnitude of the change in government policy. The IGCC recommends that the government consults further on this is best approached. With the ETS framework established, the primary risk to companies involves the permit price. The majority of companies and investors can manage the permit price risk and the financial market will soon develop ways to manage this risk.

However, changes to the ETS scheme as a result of changes in government policy, regardless of whether it is a result of international negotiations, is a risk for which government needs to accept responsibility. It should be noted that the current uncertainty with regard to the ETS and longer-term emission targets is already putting a disproportionate amount of the risk associated with addressing climate change on investors and thus the Australian economy in the longer term.

### **Proposition 4: That the scheme initially cover the stationary energy sector**

From an investor's perspective it is important that the national emissions cap is achieved with a minimal impact on the economy. Therefore, the IGCC concurs with the view that the broader the sector coverage of the ETS the more abatement options should become available, with the potential for least cost abatement. In addition, as investors across all sectors of the economy, the IGCC believes it is important that the ETS does not lead to distortions in the economy by not including some sectors.

Therefore, the IGCC believes that initially stationary energy, fugitive, and industrial process emissions should be covered by the ETS. Based on 2003 emissions data this would cover approximately 60% of Australia's emissions. Due to uncertainties in assessing emissions and administrative costs, there seems minimal advantage to include land-use change, waste and agriculture. Emissions from these sectors may be better addressed through other government policy approaches, though offsets from these sectors may be included if they can be adequately verified.

The inclusion of the transport sector requires further consideration by the working group.

As an initial position the liability should lie with the emitter, with the market addressing the distribution of costs through the economy. However, for small direct emitters, e.g. residential or small commercial users of gas, the liability should be placed upstream, i.e. on the fuel supplier, e.g. the gas retailer. A similar approach could be used for the transport sector. The exact definition for "small direct emitters" requires further consideration, covering issues such as administrative costs. The introduction of contestability into the gas markets may provide some assistance in determining what size is a "small direct emitter" and the number of potential parties liable under the scheme.

On other issues raised in the discussion paper, the IGCC believes that:

- to maintain the integrity of the system, it is recommended that large downstream users cannot opt out of the system;
- whether renewable energy is covered by the ETS will require further consideration, e.g. depending on permit allocation processes, the desirability of encouraging renewable energy sources to get diverse energy sources and the effectiveness of using other policy approaches to achieve this result, such as an extension of MRET;
- Given the nature of ownership of "emission" facilities and how they can change over time, liability, monitoring and compliance should be at a facility level. Normal accounting processes can be used to address reporting of company liabilities and transparent company structures used to provide natural hedges against the potential financial impacts of the ETS; and
- A key question is that the level of uncertainty in emission measurement and how this uncertainty is addressed, especially for fugitive emissions. It is unlikely that existing reporting schemes will provide the level of accuracy of emissions and other data required for the ETS especially given that the ETS may have significant financial



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implications to a company. Over time, with an ETS in place, the market will get more sophisticated at measuring emissions accurately. However, the IGCC believes that this requires further consideration.

### **Proposition 5: That the scheme covers all six greenhouse gases under the Kyoto Protocol.**

The IGCC believes that if all or most sectors are included in the ETS, it appropriate to cover all six greenhouse gases.

### **Proposition 6: That permit allocation be made on the basis of a mix of administratively allocated and auctioned permits, with both long and short-term permits.**

The method of allocating permits and any uncertainty around this process has the potential to significantly impact shareholder value. The impact on a particular company will depend not only the price and number of permits required by the company, but also the ability of company to pass on additional cost to customers and the ability of customers to either further pass on costs or absorb costs.

The IGCC contends that the criteria to be used in assessing the permit allocation approach should:

- focus on the objective of meeting emissions cap at the lowest price over the long term, i.e. not be seen as a means of raising revenue for government;
- be economically efficient, i.e. minimising the cost of the ETS to the economy;
- recognise that step changes in costs may have a significant impact the economy and energy intensive sectors;
- be equitable, i.e. not discriminate against sectors or new entrants;
- be effective, i.e. avoid the potential for windfall profits;
- be efficient, i.e. have minimal administration costs;
- facilitate an appropriate secondary market for permits;
- be transparent;
- be flexible to adapt to international developments in this area; and
- enable participation of Australian companies in overseas schemes.

Using these criteria, the IGCC has concerns that the auctioning of all permits may have a significant step change impact on costs for industry as the cost to participants in the ETS is significantly higher than the cost of abatement to meet any emissions cap. Auctioning will raise significant revenue for the government and while some of this revenue may be “recycled” back into the economy through subsidies or a decrease in tax levels, the IGCC has concerns that this is likely to be inefficient due to the level of administration required; lead to potential inequities as some sectors are likely to be favoured over others and potentially lacks transparency.

The experience of the EU ETS suggest that lump sum allocation, for example, grandfathering based on previous emission levels, or asset value can lead to opportunity cost pricing by the electricity generators, resulting in windfall profits. While this may be to the advantage of certain investors in electricity generation, it has the potential to significantly disadvantage investors in electricity users, in particular energy intensive industries. As investors across all sectors of the economy, the members of the IGCC do not believe this is a good outcome for the economy or investors.

The IGCC believes that linking the allocation of permits with the actual level of economic activity of the liable party responsible for the emission, e.g. basing allocation on megawatt-hours electricity produced for electricity generators, should overcome the potential for opportunity cost pricing and not disadvantage those who have undertaken early action in abating emissions or, necessarily, existing operations.

The percentage of the total permits allocated in this way should be such that the cost to the economy is minimised, though a small percentage of permits may still need to be auctioned to facilitate the establishment of the permit market. Further work on this is required.

The IGCC concurs with AFMA's comments with regard to the use of “long-term” permits to provide certainty and also has concerns over whether such instruments would be fungible with other regional or international ETS. The



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IGCC believes that the method of allocating permits and clarity on how the emissions cap changes with time are better approaches to providing certainty.

### **Proposition 9: That mechanisms be included to address adverse effects and structural adjustments**

The IGCC believes that an equitable, transparent, efficient and effective permit allocation scheme can significantly address the potential adverse impacts or short term shocks, and assist in structural adjustment as a result of the introduction of the ETS.

However, there may be some sectors or industries, socioeconomic groups or regional areas that require additional assistance to adjust to the impacts of the ETS. Until critical aspects of the ETS are determined, e.g. emissions cap, rate of change of emissions cap, permit allocation method and other normal economic issues, such as normal asset turnover, it is difficult to evaluate the potential impacts and consequently the most appropriate way to address these issues.

The IGCC also believe that there will also be significant investment opportunities available from the introduction of such a scheme and governments should also focus on mechanism and policies to promote new technology and practices that will benefit the Australian economy and facilitate the transition of the economy.

### **Proposition 10: That mechanisms be included to allow transition for participants who have taken early abatement action and new entrants**

The IGCC believes that an appropriate permit allocation approach, such as one linked to the economic activity undertaken, rather than historic emissions, can address the majority of issues for those who have undertaken early action and new entrants.

In considering mechanisms to address those who have undertaken early action it is important to recognise that the basis for most early action through the “Greenhouse Challenge Program” was on a “no regrets” basis. Therefore, a more appropriate focus is that those who have not undertaken early actions do not get advantaged as a result of the permit allocation process.