Investor Group on Climate Change

Submission
Safeguard Mechanism Reforms: Consultation paper

September 2022

Summary of investor responses

IGCC represents investors with total funds under management of more than $3 trillion in Australia and New Zealand and $30 trillion around the world.

Safeguard changes are relevant to investors because:

1) Institutional investors have the capital to finance a clean energy economy. As the long-term custodians of trillions of dollars in retirement funds, investors have a fiduciary duty to deliver long-term returns for their beneficiaries. Unless climate change is addressed in an orderly and just way, the long-term retirement savings of millions of Australians are under threat.
2) Many of IGCC's members have significant exposure to climate risk via their listed equities and fixed income portfolios. This includes their part-ownership of companies that are covered by the Safeguard Mechanism.
3) Australia's economy is the most emissions intensive in the OECD exposing the economy to relatively high climate-related transition risks including that of stranded assets.
4) Emissions from industries covered by the Safeguard Mechanism continue to grow:
   a) offsetting emissions reductions achieved in other sectors
   b) making it harder for the overall economy to achieve emissions reductions goals, and
   c) increasing climate-related investment risks across the financial system
5) The Safeguard Mechanism covered some of the industries and sectors that will be critical to ensuring an orderly and just transition to net zero emissions and limiting climate damages above 1.5°C. Achieving these outcomes will require significant investment and support from institutional investors.

A Reformed Safeguard is Essential to Australia's Competitive Advantage

IGCC supports the Government's intention to use "*the Safeguard Mechanism to deliver emissions reductions consistent with Australia's Nationally Determined Contribution under the Paris Agreement and strengthen Australia's competitiveness in a decarbonising global economy.*"

The biggest climate-related transition risk to Australia stems from not positioning our economy to be prosperous in a net zero world. Policies that support the widespread dissemination of carbon price signals will incentivise investments into emission reductions across the economy and increase out competitive advantage overall.

In this context, IGCC notes the Government intends to exclude electricity emissions from the current round of Safeguard Mechanism consultations. In future, the role of the Safeguard Mechanism in the National Energy Transformation Partnership to promote an orderly and just transition to new zero emissions in electricity sector should be considered.

The role of the Safeguard in a 1.5°C world

Deciding upon the Safeguard Mechanism's optimal share of climate targets relies on the Government having set both national emissions goals and sector-by-sector goals to align with the overall long-term emission reduction target (e.g., limiting damages above 1.5°C). Therefore:

- In the absence, of clear and transparent sectoral goals to achieve long-term national goals, Phase I share should be aligned with a linear reduction from 2020 emissions to a 43% reduction by 2030.
- Phase 2 and future shares should be based on advice from the Climate Change Authority on clear 2030, 2035 and 2040 policy goal posts for all sectors and be aligned with limiting climate damages from global warming above 1.5°C
- New entrants should be captured under this sectoral share to avoid shielding them from the national task and passing on costs to the rest of the economy.

Reforms should ensure that that, by default and at a minimum, emissions baselines decline to 0 by 2050. These longer-term indicative baselines would provide visibility of future climate risks and opportunities and support early investment in low and zero emissions upgrades and projects.

Baselines, flexibility mechanisms and offsets

On other specific questions, IGCC recommends:

- **Baseline type:** Build on industry production adjusted (intensity) baselines
- **Headroom:** Immediate removal
- **Backing and borrowing:** Facilities should be able to bank and borrow emissions within the phases of the scheme. There should be no overlap from one period to another
- **Offsets:** Facilities should not be able to generate Australian ACCUs once the safeguard system is in place. Role of international units should be reviewed in future

Emissions Intensive Trade Exposed industries

Shielding unsustainable operations and sectors from the Safeguard Mechanism and overall emissions reduction targets will increase Australia's overall cost of achieving emissions reductions and will push effort onto other sectors of the economy.

Therefore, any transitional competitiveness measures should:

- focus on those industries that have a clear future in an Australian net zero emissions economy (e.g., renewable energy, critical minerals, and green steel, hydrogen and aluminium)
- not be provided to industries that will decline in a net zero economy, such as coal and LNG. Support towards these sectors should be limited to the development of near-zero emissions technologies and collaboration to support a just transition for affected employees and communities.

In this context none of the proposals to address EITE's within the Safeguard Mechanism architecture are satisfactory. Setting Paris and technology aligned pathways for hard to abate sectors and the flexibility mechanisms proposed would give entities a sufficient range of options to manage their liabilities at least cost without additional shielding that will increase the overall economic cost of the policy.

Given the compliance cost associated with the Safeguard Mechanism will be relatively small, instead of shielding industries within the policy, governments should focus on robust flexibility mechanisms, and direct support to these industries using non-Safeguard Mechanism options (e.g., technology, just transition funding).

For more information, please contact Erwin Jackson, Director, Policy, IGCC: erwin.jackson@igcc.org.au

Introduction

The Investor Group on Climate Change (IGCC) welcomes the opportunity to provide an institutional investor perspective on the proposals with the Government's *Safeguard Mechanism Reforms: Consultation paper*.

IGCC is a collaboration of Australian and New Zealand institutional investors focused on the impact of climate change on investments. IGCC represents investors with total funds under management of over $3 trillion in Australia and New Zealand and $30 trillion around the world.

Institutional investors have the capital to finance a clean energy economy.

As the long-term custodians of trillions of dollars in retirement funds, investors have a fiduciary duty to deliver long-term returns for their beneficiaries. Unless climate change is addressed in an orderly and just way, the long-term retirement savings of millions of Australians are under threat.

Institutional investors are, and will continue to be, co-owners of companies and assets throughout the Australian and global economies, which means that climate is a risk they cannot divest from. Therefore, institutional investors must act within their portfolios and engage with businesses and policymakers to collaborate on climate solutions.

Government policy provides the signals and incentives that direct the flow of capital across the global economy. Credible, investable, and durable policy frameworks put in place today will not only support strong investor and beneficiary returns into the future but also enhance Australia's economic competitiveness and help attract international capital.

Investors do not advocate for unnecessary subsidies but do require a supportive, credible, consistent and stable policy environment that will facilitate private investment by reducing policy-related sovereign, transition and physical risks and shape markets for climate solutions.

Investors support the direction of government policy

IGCC supports the Government's intention to use "*the Safeguard Mechanism to deliver emissions reductions consistent with Australia's Nationally Determined Contribution under the Paris Agreement and strengthen Australia's competitiveness in a decarbonising global economy.*"

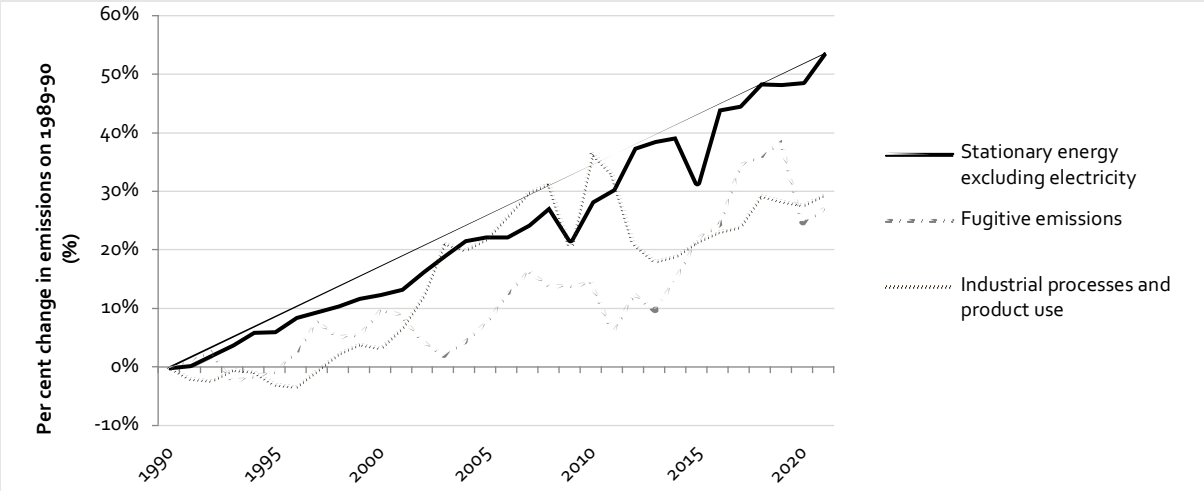
Safeguard changes are relevant to investors because:

1. Many of IGCC's members have significant exposure to climate risk via their listed equities and fixed income portfolios. This includes their part-ownership of companies that are covered by the Safeguard Mechanism. Investors engage with these companies on their net zero targets, strategies, disclosures, and capital allocations with the goal of supporting these companies as they manage short- and long-term climate risks and opportunities, e.g., see Climate action 100+.[1]
2. Australia's economy is the most emissions intensive in the OECD.[2] Unless this is addressed, Australian and international investors, who increasingly factor in carbon emissions into their investment decisions, will conclude that Australia is becoming an increasingly less attractive and increasingly exposed to climate-related transition risks including that of stranded assets.
3. Emissions from industries covered by the existing Safeguard Mechanism continue to grow, offsetting emissions reductions achieved in other sectors, making it harder for the overall economy to achieve emissions reductions goals, and increasing climate-related investment risks across the financial system (See Figure 1).

[1] https://www.climateaction100.org/
[2] OECD database, https://stats.oecd.org/Index.aspx?DataSetCode=AIR_GHG.

4. Australia also has the potential to be a prosperous and vibrant economy in a net zero world. The country has all the potential ingredients necessary to attract investment, across the economy, to achieve net zero emissions by 2050. There are export opportunities, which will be driven by increasing demand for existing and new products, including green steel and aluminium, green hydrogen and many critical raw materials. The Safeguard Mechanism covers some industries and sectors that will be critical to ensuring an orderly and just transition to net zero emissions.

Figure 1: Emissions from the sectors covered by the currently proposed Safeguard Mechanism are continuing to rise.[3]



A Reformed Safeguard is Essential to Australia's Competitive Advantage

Well designed, robust and transparent carbon pricing sends market signals, allows accurate pricing of the cost and impact of emissions, and incentivises behavioural change and investment flows into lower and zero emissions solutions. Policy frameworks and signals that support the widespread dissemination of carbon price signals will incentivise investments into emission reductions across the economy and increase our competitiveness overall.

The more carbon is explicitly priced, the more investment will flow to new zero emissions technologies and the more efficiently industry will align with economic and overall policy objectives to decarbonise the economy.

Markets and many businesses are currently integrating carbon price assumptions into investment decisions and forecasting.[4,5] The increase in emissions in several sectors demonstrates that reliance on this voluntary approach is insufficient to achieve the reductions Australia needs to achieve to be net zero by 2050. Increasingly, Australia will also be unable to escape carbon pricing in global market decisions, or through explicit global pricing mechanisms such as the Carbon Border Adjustment Mechanism.[6]

[3] Australian Government (2022), Quarterly Update of Australia's National Greenhouse Gas Inventory: March 2022: https://www.dcceew.gov.au/climate-change/publications/national-greenhouse-gas-inventory-quarterly-updates
[4] Golman Sachs (2020), Carbonomics, https://www.goldmansachs.com/insights/pages/gs-research/carbonomics-10-key-themes-from-the-inaugural-conference-f/report.pdf.
[5] The Grattan Institute (2022), Submission Safeguard Mechanism Reform Consultation.
[6] The Australian Industry Group (2021), Swings and roundabouts: The unexpected effects of Carbon Border Adjustments on Australia, https://cdn.aigroup.com.au/Reports/2021/Carbon_Border_Adjustments_Policy_Paper.pdf.

An immediate priority in Australia is to ensure the country's existing carbon pricing mechanism – the Safeguard Mechanism – is aligned with avoiding climate damages from warming above 1.5˚C.

In this context, IGCC notes the Government intends to exclude electricity emissions from the current round of Safeguard Mechanism consultations. None-the-less, a policy mechanism that incentivises the early and managed exit of coal and gas-fired generation and its replacement with zero emissions technologies is the least-cost outcome for the economy. In future, the role of the Safeguard Mechanism in the National Energy Transformation Partnership to promote an orderly and just transition to new zero emissions in electricity sector should be considered.

Comments on specific questions

Question	Comment
Safeguard Mechanism's share of Australia's climate targets	
What should the Safeguard Mechanism's share of Australia's climate targets be?	The share of the Safeguard Mechanism contribution should be guided by the following principles and goals: - Achieving Australia's current 2030 Nationally Determined Contribution - Limiting climate damages from global warming above 1.5°C - Meeting the Government's broad policy objectives -effective, equitable, efficient, and simple - Maintain direct abatement incentives across covered sectors, while at the same time recognise that different technological pathways to net zero exist in different sectors - Avoid a disorderly transition to net zero emissions and loss of international competitiveness from failing to match more credible policy settings in other countries. However, deciding upon the Safeguard Mechanism's optimal share of climate targets also relies on the Government having set both national emissions goals and sector-by-sector goals that cumulatively meet the overall emission reduction target (e.g., limiting damages above 1.5°C). Such sector-by-sector goals are not yet defined and are therefore not provided in the discussion paper. Establishing sector targets to guide policy development will inform investor expectations on future policy. It will also establish performance benchmarks for future policy review and development. Sector targets contribute to a clear framework for investors and the companies they own, guiding business strategy, targets and metrics and allocation of capital towards new technology and/or other expenditure. Once national and sector goals are set, the Safeguard Mechanism's share should be decided. Therefore: - Phase I share should be aligned with a linear reduction from 2020 emissions to a 43% reduction by 2030 (see also discussions of long-term default baselines below).

	- Phase 2 share should be based on advice from the Climate Change Authority on clear 2030, 2035 and 2040 policy goal posts for all sectors and be aligned with limiting climate damages from global warming above 1.5°C - New entrants should be captured under this sectoral share to avoid shielding them from the national task and passing on costs to the rest of the economy.
Fixed (absolute) versus production-adjusted (intensity) framework	
Should we retain, and build on, the existing production-adjusted (intensity) baseline setting framework or return to a fixed (absolute) approach?	There are significant positives and negatives with both proposed approaches. On balance, IGCC recommends building on industry production adjusted (intensity) baselines[7] as it, - Connects the benefits, which has monetary value, for example, Safeguard Mechanism Credit, with an activity which adds economic value - It recognises and benefits those facilities who are more emission efficient and may have undertaken emissions prior to the implementation of the proposed revision to Safeguard Mechanism We recognise that the current baselines, and the current headroom, are not appropriate and need to be adjusted (see below) for the scheme to work effectively.

[7] The use of industry emission intensity framework does mean that the decrease in the baseline industry emission intensity does need to recognise changes in the industry production. This creates greater uncertainty around the facilities contribution to the overall Safeguard Mechanism emissions limit.

Setting baselines for existing and new facilities	
Views are sought on the proposal to reset baselines in a way that removes aggregate headroom so crediting and trading can commence when baselines start to decline.	Early action and investment will be supported by the immediate removal of headroom. The ability to access Safeguard Mechanism Credits can be an incentive for companies and investors to support earlier decarbonisation projects and upgrades.
What is the preferred approach for setting baselines for existing facilities?	Industry-average benchmark emissions-intensity values, as it rewards more emissions-efficient facilities.
What are the advantages of best practice, industry average benchmarks or alternative approaches for setting baselines for new entrants, noting that a final decision will be informed by baseline setting arrangements for existing facilities?	The industry average benchmark should be applied. This approach rewards new entrants that use better (lower emissions) technologies early in the facility's life (improving NPV). It also avoids the need for multiple benchmarks as new entrants come in over time.
Crediting and trading, domestic offsets and international units	
Are there any other issues to consider with the proposal to allow the Clean Energy Regulator to automatically issue tradable credits to Safeguard facilities whose emissions are below their baseline, with crediting and trading commencing on 1 July 2023 subject to baseline setting arrangements that remove aggregate headroom?	The materiality test for being covered by the Safeguard Mechanism should be decreased over time, i.e covering facilities with scope 1 emissions lower than 100,000 tonnes. Approximately 40 facilities have emissions of 120,000 tonnes or less. To reach 2030, 2035 and 2050 emissions targets more facilities will need to be captured and incentivised to reduce emissions through time.

Should banking and borrowing arrangements be implemented for Safeguard Mechanism Credits?	Facilities should be able to bank and borrow emissions within the Phases of the scheme. There should be no overlap from one period to another and especially for borrowing.
Should Safeguard facilities no longer be able to generate ACCUs for reducing direct (scope 1) emissions unless they have an existing registered ERF project? Further, should no new ERF projects be able to be registered at Safeguard facilities? Additional feedback is sought on: - allowing existing ERF projects at Safeguard facilities to continue to generate credits and retaining double counting provisions to prevent a facility from generating ACCUs and SMCs; - options for the treatment of deemed surrender; - continuing to allow Safeguard facilities to participate in ERF projects that reduce emissions from electricity use (scope 2) emissions; and - mechanisms to promote the transparency of the ACCU market, such as publishing unit holding, to assist with market decision making, supply and cost effectiveness. Should international units be able to be used for compliance under the Safeguard Mechanism at a future time, noting that any decision would depend on the rules for international trading?	Facilities should not be able to generate Australian ERF units once the safeguard system is in place, and the use of international units should be reviewed in the future. The underlying principle is that the use of national and international carbon offsets must be considered in the context of how and when they are being used. Carbon offsets are a useful mechanism to immediately net out emissions from industrial practices, and some consumer-based products and services, where immediate emissions reductions options are not available. However, the use of offsets to meet emissions targets is increasingly being scrutinised by investors: Businesses and projects that rely heavily on offsets face significant transition risks, and investors' concerns include that offset mechanisms can be used as a delaying tactic by high emitters, slowing the necessary transition and locking in heightened risk of carbon price and stranded assets. For investors, the integrity of offsets is also critical; investors need to have confidence in the market. For this reason, investors advocate for offsets that deliver actual emissions reductions, have verification of lifecycle emissions and regulatory regimes that enforce these standards.

Tailored treatment for emissions-intensive, trade-exposed (EITE) businesses	
Should a facility-specific comparative impact assessment that builds on existing EITEs definitions be used rather than a sector wide designation? Would additional funding opportunities effectively assist EITE facilities to adapt to declining Safeguard baselines? What kinds of funding, finance or other arrangements and measures would best support EITE Safeguard facilities to reduce their emissions? In particular, what potential design features of the Powering the Regions Fund would support covered facilities with their decarbonisation priorities?	Shielding unsustainable operations and sectors from the Safeguard Mechanism and overall emissions reduction targets will increase Australia's overall cost of achieving emissions reductions and will push effort onto other sectors of the economy. Therefore, any transitional competitiveness measures should: • focus on those industries that have a clear future in an Australian net zero emissions economy (e.g., renewable energy, critical minerals, and green steel, hydrogen and aluminium) • not be provided to industries that will decline in a net zero economy, such as coal and LNG. Support towards these sectors should be limited to the development of near-zero emissions technologies and collaboration to support a just transition for affected employees and communities. IGCC recognises the Government faces significant policy challenges in addressing EITE businesses. Previous policy discussions in Australia have focused on shielding industries from the lack of action in competing nations and the risks of carbon leakage. However, since then three major changes have occurred: • Near universal commitment to achieving net zero emissions from all major economies. While patchy, these countries are implementing policy to drive economic and industrial policy towards net zero emissions. In response to the Ukrainian crisis, national policies are generally accelerating the transition always from fossil fuels. This is impacting global capital flows and without strong national policy settings Australian companies' risk being left behind to the global race for net zero capital. • Australia's and the world's largest corporate emitters are committing to net zero emissions. This is in response to the above and investor expectations around how companies manage climate risks and opportunities. For example, as of March 2022, 69% of the world's largest corporate greenhouse gas emitters had set commitments to achieve net zero emissions by 2050.[8] Table 1 below summaries Climate Action 100+ last climate benchmark indicators for Australian high emitting companies impacted by the Safeguard Mechanism. It illustrates that while companies are

[8] IGCC (2022), *Climate Action 100+ Net Zero Company Benchmark*: https://igcc.org.au/climate-action-100-net-zero-company-benchmark-2022/

committing to achieve net zero by 2050, current capital allocations are not aligned with achieving this goal or meeting science-based 2030 emissions targets. This is part reflects the lack of long-term, stable and effective climate policy in Australia. Current policy settings and their misalignment with the Paris Agreement does not currently support investment in 1.5°C pathways.

Also, lobbying by vested interests has significantly delayed effective climate action over the last few decades and increased system wide financial and economic risks associated with climate change.[9] As Table 1 shows, some of Australia's largest emitting companies have committed to align their lobbying activities with achieving the objectives of the Paris Agreement. Investors will be seeking to ensure corporate lobbying activities are aligned with achieving the best overall economic benefit and limiting climate change damages from warning above 1.5°C.

Finally, also the relative impact of proposed Safeguard Mechanism changes on companies' performance are likely to be small. Companies routinely stress test assets against carbon prices of USD100-130/tonne in 2030 and generally report to investors and the market that their assets and companies are resilient to carbon prices at these levels.[10] Note also that emitters will not be paying for every tonne they produce, and only those above their baselines. This reduces the carbon costs to these industries substantially.

- Investors in Australia and globally are committing to aligning their portfolios with net zero emissions and Paris aligned 2030 goals. For example, within IGCC's membership, which comprises Australia's largest investors, 78% of Asset Owners and 66% of Asset Managers have committed to net zero by 2050 or earlier.[11] Capital is mobile and to achieve these targets investors will need realign their portfolios, preferencing companies, technologies, *and countries* with credible net zero transition strategies.

Together, these changes, significantly reduce but do not eliminate concerns around carbon leakage. The Government should avoid responding to individual companies' rent seeking and political lobbying, resisting their calls to disproportionally shield companies from relatively small carbon compliance costs, a measure which would transfer costs and risks to the rest of the economy.

[9] IPCC (2022), Climate Change 2022: Mitigation of Climate Change: https://www.ipcc.ch/report/sixth-assessment-report-working-group-3/
[10] Some companies developed and report against their own carbon prices assumptions. Most use carbon prices from either the IEA SDS and/or NZE emissions scenarios: https://www.iea.org/reports/world-energy-model/macro-drivers
[11] A further 18% and 23% respectively are in the process of setting their targets. - IGCC 2022 Annual Survey of Members

	In this context none of the proposals to address EITE's within the Safeguard Mechanism architecture are satisfactory. Setting Paris and technology aligned pathways for hard to abate sectors (see sector targets above), and the flexibility mechanism proposed, would give entities a range of options to manage their liabilities at least cost without the additional shielding that will increase the overall economic cost of the policy. Instead of shielding industries within the Safeguard Mechanism, governments should focus on robust flexibility mechanisms, and direct support to these industries using non-Safeguard Mechanism options (e.g. technology, just transition funding). The Government should also examine mechanisms like Carbon Border Adjustment Mechanisms that maintain strong abatement incentives while at the same time address current, but diminishing, carbon leakage concerns.
Is the direct provision of SMCs an appropriate way to mitigate cost impacts for EITE facilities?	No. This proposal would: - take away demand side incentives to reduce emissions an increase transition risks - be inequitable as all companies need to contribute to reducing emissions, even if it is paying someone else to reduce them for them through Safeguard Mechanism Credits
Are differential decline rates an appropriate way to reduce the impact on EITE facilities?	Decline rates should reflect the change in production within the sector and not be EITE based. Therefore, if production in a sector is increasing then the decline is quicker. If production is decreasing, then the decline rate should be the minimum decline rate under the circumstance there is no increase in production. Thus, if a facility closes and isn't replaced by something else then the emissions from that facility are essentially banked as reductions and can be used to reduce the overall decline rates of all facilities in the next period.
How could differential decline rates be structured so that emissions reduction and fairness outcomes are maintained?	By not having a differentiated reduction based on EITE.

Indicative baseline decline rates	
What are the appropriate characteristics for the decline trajectory to 2030 that can deliver the Safeguard Mechanism's share of Australia's climate targets, and the process for setting baselines post-2030?	Reforms should ensure that that, by default and at a minimum, emissions baselines decline to 0 by 2050. These longer-term baselines would provide visibility of future climate risks and opportunities and support early investment in low and zero emissions upgrades and projects. Legislative provisions should ensure that the baselines are regulated at levels as strong as the default long-term trajectory. Future regulated compliance period baselines should be aligned with sector pathways to achieve 1.5°C as outlines above and set during Australia's updated NDC processes.

Table 1: Investor benchmarks of Australian Climate Action 100+ companies impacted by the Safeguard Mechanism

	Net zero by 2050 (Scope 1-2)	Mid-term target (Scope 1-2) (Red = Yes, but not Paris Aligned)	Decarbonisation strategy to meet targets	Capital-aligned with targets	Climate policy alignment*	Climate governance	TCFD alignment
Adbri Limited	Y	Y	Y	N	N	Partial	Partial
BHP Group Limited	Y	Y	Y	N	Y	Y	Y
Bluescope Steel Ltd.	Y	Y	Y	N	N	Partial	Y
Boral Ltd.	Y	Y	Y	N	N	Partial	Partial
Incitec Pivot Limited	Y	Y	Y	N	N	Y	Y
Orica Ltd.	Y	Y	Y	N	N	Partial	Y
Origin Energy Ltd.	Y	Y	Partial	N	Y	Y	Y
Rio Tinto Limited	Y	Y	Partial	Partial	Y	Partial	Y
Santos Ltd.	Y	Y	Y	N	Y	Y	Y
South32 Ltd.	Y	Y	Partial	N	N	Partial	Y
Woodside Energy Group	Y	Y	N	N	Y	Partial	Y

* The company has a Paris Agreement-aligned climate lobbying position, and all its direct lobbying activities are aligned with this.