42/120 Collins Street GPO Box 1472 Telephone +613 8664 2664

Melbourne 3000 Melbourne 3001 Facsimile +613 8664 2666

www.bca.com.au

SPEECH

Business Council of Australia

The Great Climate Change Challenge

Address to the Sydney Institute
27 August, 2008, 6pm
Minter Ellison,
Level 19, 88 Phillip Street,
Sydney

Greig Gailey
President
Business Council of Australia

Introduction

The design, passage and implementation of a national emissions trading scheme is the single most important decision the Rudd Government will make in its first term.

This is an incredibly complex problem, with many difficult aspects. For instance, Ross Garnaut in his report rightly described the dilemma of emissions-intensive, trade-exposed industries, or EITEs, as a “truly dreadful problem”. I would suggest that on a broader scale the implementation of an emissions trading scheme also constitutes a grisly political problem for a government of any persuasion.

The Business Council of Australia (BCA) is committed to helping the government devise an effective emissions trading scheme. To do this, we need a frank discussion of how to deal with and minimise the real costs which an emissions scheme will impose on the economy.

We are committed to the principle that business should bear some of the burden of that scheme. We are committed to finding opportunities for innovation and new business opportunities.

The BCA Supports Australia Addressing the Climate Change Challenge

Last week the BCA released a report titled *Modelling Success*. I don't intend to go through the detail of this report this evening. For those of you who would like to read the report it is available on the BCA website.

Although this report was generally well received, and well received by the government, it was regrettably seen in some quarters as big business yet again being negative and failing to assist Australia to address the challenge of climate change.

We don't see ourselves as qualified to have an independent view of the science of climate change one way or another. It is rightly the prerogative of government to determine this based on the weight of scientific evidence. And it is their view that the weight of scientific evidence says that global warming is a problem, a global problem. A global problem which Australia must take its part in addressing.

Let me state clearly and unequivocally, yet again, that the BCA does not oppose the government's intention to address climate change.

The BCA wants to play its role in assisting Australia to do this.

What Are We Trying to Do?

It is accepted that Australia alone cannot solve the problem of global climate change. We account for just 1.6 per cent of global carbon emissions. What we can do, however, is take a position which will influence the global debate. We can be amongst the first movers. We can show the world that it can be done. We can show

the world that it can be done without unduly harming our economy. This, to my mind, is the real prize, for Australia – to be a role model for others to follow.

In July the government released its Green Paper which provided the first real detail of how Australia would do this. The government intends to introduce an emissions trading scheme which it has called the Carbon Pollution Reduction Scheme (or CPRS for short). The BCA fully supports this intention.

The CPRS is designed to incorporate the negative societal costs of pollution into the price of the energy which we generate and use. Hitherto this pollution has not been costed or priced into the energy we use. By factoring the cost of this pollution into the energy we use, we will be motivated to both constrain our use of energy and produce that energy from less polluting sources. The government proposes, and the BCA supports, that this pollution will be priced by way of charging for every tonne of CO_2 that is emitted to the environment. Every tonne of CO_2 emitted to the environment will require the purchase of a permit from the government.

In doing this – at least for the next decade until technology advances beyond where it is today – we will be making the energy we use more expensive. The greater the price we charge for permits, the more expensive that energy will be.

These costs will by definition be passed through to consumers. Business has no capacity to magically absorb unlimited cost increases due to emissions trading, any more than it does to absorb any other substantial cost increase. A high enough cost increase will wipe out profits, leaving a board with no alternative but to close the business. A smaller cost increase may still lower profits so far that the business activity has to shrink dramatically.

In a perfect world, if Australia were a closed economy and had no interaction with the rest of the world, emissions trading could theoretically, in the very short term at least,

be a zero sum game – provided that the government were committed to returning to the community all of the revenue it generated from selling permits. The government is indeed committed to returning all of the revenue it raises from selling permits; however, we do not live in a perfect world. There are a number of reasons why the amount of money returned to the community will fall short from that collected from the sale of permits.

Firstly, there is the issue of churn. That is to say, there are costs associated with both collecting and returning the monies.

Secondly, the government has indicated that it desires to see some of this money invested to encourage the research and development that is needed to develop presently immature low-emission technologies such as solar, biomass and carbon sequestration.

There is also the issue of the implementation of these low-emission technologies which reduce emissions but, at least in the short term, push up real costs. Electricity generators will need to make the bulk of these investments if Australia is to achieve its desired emissions reductions. To enable them do this, they almost certainly will require transitional assistance. The government acknowledges this and agrees that assistance will be needed.

Lastly there is Ross Garnaut's "truly dreadful problem", the vexed and difficult issue of the EITEs. This group of companies either sell the bulk of the goods they make to consumers outside Australia where for the immediate future, they will face competitors who do not incur a carbon cost, or compete with imports manufactured in countries where carbon is not priced. This latter dimension is an important aspect since it considerably widens the number of industries categorised as EITE. Either way, these companies do not have the capacity to pass on the higher cost arising

from pricing carbon to their customers. The government also acknowledges that EITEs will also need to be assisted if they are to remain in business.

As you can see there is already a substantial claim on the monies that will be raised from the sale of permits.

And I have not included the 1.5 billion dollars of permit revenue that will be required to offset the loss of excise revenue in the first year as a result of the government's decision to give cent for cent relief to motorists to offset higher petrol and diesel prices.

Collectively, the monies used for these purposes reduce the amount of money that is available to return to domestic consumers, particularly low-income or other vulnerable groups. The less money that is available to return to domestic consumers, the more direct cost they bear as a result of the introduction of the CPRS.

Let's be realistic at this point and openly acknowledge that domestic consumers are also voters. And it is likely that there are limits to the financial pain that these voters will bear. Hence my early categorisation of this as a grisly political problem for a government of any persuasion.

The Real Debate

This is the crux of the problem that we are wrestling with. Regrettably, I fear that, as is usually the case, the debate is likely to focus on who bears what share of the pain rather than standing back and reminding ourselves what we are trying to do and how much we are prepared to pay for it, which is the real debate we should be having. The debate about how far and how quickly do we want to move ahead of our global neighbours and how much are we prepared to pay to do so.

A debate which we should have with our eyes open and with a full understanding of the costs involved.

The BCA Report

Last week's BCA report was designed to help us to understand how well the mechanisms proposed in the Green Paper to assist EITEs and the electricity sector during the implementation of the CPRS would work in practice and to understand if the government's objectives were likely to be achieved of:

- Reducing Australia's greenhouse gases
- Continuing to have a strong Australian economy
- Making Australia a global role model.

The BCA report provided data that has not previously been available to either government or organisations like the BCA.

The report detailed the results of a study that the BCA commissioned from Port Jackson Partners (PJP) to understand the impact of the government's CPRS on both the electricity sector and emissions-intensive, trade-exposed businesses.

The study covered 14 representative Australian companies in 12 industry sectors. This is the first major study which looks at real companies and evaluates the real financial implications of introducing the CPRS. We are confident that the impact on these 14 case studies would be repeated for many others across each of their sectors.

How much assistance do these sectors need if we are to avoid unduly damaging our economy? If we choose to constrain assistance to these sectors such that we damage our economy we are simply disguising the real cost of our decision to be a

first mover in addressing climate change. In so doing we will also likely fail in what I still believe should be our primary goal – to be a global role model. Others will hardly be likely to follow us if they see that the price is an impaired economy.

Let's look at the issues this work throws up.

Emissions-Intensive, Trade-Exposed Businesses

EITEs represent and important part of the Australian economy. Many of the goods we make and sell to the world "to earn our keep" are energy intensive, that is, they use a lot of energy. They are also globally traded goods whose price is set by the lowest-cost producers – wherever they may be.

This is true of both companies who export the goods they make in Australia and for companies who manufacture and sell locally but sell in competition with imported goods where the price is set by the cost of the import.

Broadly speaking, EITE industries account for 51 per cent of Australia's export earnings and employ up to 1 in 10 or around 924,000 Australians They are a very important part of our economy. Generally speaking they are in sectors where Australia has a competitive advantage.

Most of these companies are price takers and do not have the ability to pass a carbon cost onto their customers. This means that they will directly bear the increased costs arising from the CPRS.

Our research shows that at carbon price of $20 per tonne without any compensation, these companies will be severely impacted with a median 27 per cent reduction in EBIT. Additionally, the cash flow impact on almost a quarter of the 14 would be so severe that they would have no choice but to close.

As I have already said the government recognises that some compensation must be given. However, even with compensation the compensation proposed in the Green Paper with around 20 per cent of permits being provided free to this sector, the impact is still so severe that:

- 3 of the companies would have to shut.
- 4 will fundamentally review their operations to remain viable after losing between 32 per cent and 63 per cent of their pre-tax earnings.
- The rest will take immediate action to reduce their costs.
- Many potential investments will not take place.

This impact is exacerbated by some aspects of the design of the government's proposed compensation mechanism which is based on tonnes of CO_2 per million dollars of revenue. This mechanism exposes companies to the full price risk and greatly increases the impact on their profitability as the carbon price rises. For example if a company is required to buy 50,000 permits, the cost of those permits doubles if the price of carbon is set at $40 rather than $20 per tonne with no change in its revenue.

However, even if these distortions are removed and assistance were to be provided on the basis of some measure linked to profitability, such as value add as the BCA has suggested, as research still shows that at carbon prices above $20 per tonne, the level of assistance required to assist EITEs becomes sufficiently large so as to leave the balance available to compensate consumers outside of the Government's comfort level.

So why not just constrain the assistance offered to them? Why should we care if EITEIs fail? As some have pointed out, they are after all heavy polluters and would the world not be better off without them? We should care for a number of reasons.

Australia would lose valuable export earners. EITEs account for 51 per cent of Australia's exports. Jobs and investment will be lost. I might also add that a number of these industries are located in regional centres where the opportunities for alternative employment will be limited and the effect on working families could be devastating.

We would also be destroying many industries which we have a natural competitive advantage. Any expert in international trade will tell you that it isn't easy creating export industries in which you enjoy a natural advantage. With a common price for carbon and level global playing field these industries Australia would continue to have a competitive advantage in many of these businesses. Their competitive disadvantage is therefore most likely to be only temporary

These industries produce important economic inputs like steel, aluminium, petrol. Our economy is unlikely to prosper without these goods. Without local production we will be forced to import unless the Government moves to restrict imports which I believe would be highly unlikely. Increased import demand will likely lead to increased production offshore. Given the region of the world in which we live, imports are likely to come from less developed countries with considerably less rigorous environmental standards that do not yet price carbon. Similarly the good Australian EITEs export are likely to be replaced by expanded production in these same countries.

Since the goods concerned will still be manufactured, this will not reduce global emissions. On the contrary there is a reasonable argument that it will increase them.

Under these circumstances, Australia would achieve its emissions reductions by simply exporting them offshore. This is what is known as carbon leakage.

The Electricity Sector

The electricity sector faces a different problem to EITEs. Power generation is the single largest emitter of CO2. Any significant target to reduce CO2 will require fundamental change in the sector. New low emission sources of electricity generation will need to be added to meet increased demand and to substitute for current coal fired generation. The combination of this growth and substitution requirement means that a 10% reduction in emissions by 2020 in fact represents a 34% reduction on the business as usual case. This is a big ask in investment terms and would require the industry to invest something like $4 billion dollars each and every year in the decade after 2010. This is considerably higher than the Industry has managed in recent years. Much of this investment would be required in gas generation and this in turn would require the development of new gas fields. Wind power would likely have to increase sixfold and there would need to be investment in emerging and still immature technologies such as solar. All of this would have to take place against a background of significant upheaval where existing coal fired generators, and particularly brown coal fired generators, would see significant diminution in the value of their existing investments. Depending on the carbon price there is the prospect for some coal fired generators that asset impairment would be so severe as to render them insolvent.

The higher the carbon price and the more severe the emissions reduction the more problematical the position of the electricity generators.

The BCA has not put a specific proposition on the table as to what assistance should be offered to electricity generators. We simply point out that what is being asked of

them is huge. Without some assistance it is highly unlikely that the new investments required to migrate to low emissions generation will occur and there is a very real risk that supply disruption will occur as coal fired generators struggle financially.

Treasury Modelling

In October we can expect to receive the results of the economy-wide econometric modelling being done by Treasury. Ross Garnaut will also provide some modelling when he releases his final report in September. Without wishing to pre-empt the results of this modelling, I would like to highlight a significant difference between the BCA modelling and that this is likely to emanate from Treasury. Because of its longer term, Treasury modelling will likely smooth the short term dislocations of industry restructuring. It will likely assume that if Australia looses a number of EITEs as a result of the introduction of the CPRS, new industries will rise up to replace them. There is indeed an element of truth in this. However we should not make light of the very real hardship that such restructuring would involve nor should we lose sight of the fact that we would be restructuring out of industries where Australia currently has a competitive advantage and would with a global price on carbon continue to have a competitive advantage.

Sharing the Pain

Just in case you think I am advocating a free ride for Industry, let me make it clear that there is nothing in the BCA submission that suggests that Industry should not share some of the costs associated with the introduction of a CPRS. On the contrary, the alternative mechanism which we have proposed for assisting EITEs would see them incur a median reduction in EBIT of between six per cent and nine per cent if they were not able to find offsetting cost or efficiency improvements. This is not an inconsequential contribution.

Bipartisanship

Let me make one final point before I sum up.

I said earlier that the introduction of the CPRS was the single most important decision that the Rudd government would make in its first term. It is probably the most significant economic decision any government will have made since the introduction of the GST.

As such the BCA believes that it must be a bipartisan decision. Uncertainty is the great enemy of investment. Business needs certainty, particularly with regard to such major issues as the CPRS. If investors judge that the CPRS is going to be materially altered if and when government changes hands, they will likely defer or abandon their investment plans.

The BCA implores the Government and the Opposition to work together constructively on the design and implementation of the CPRS. The impact of the CPRS is just too great for us to be at the mercy of party politics. We ask both parties to forswear opposition for opposition's sake.

This may seem a big ask. But it is precisely what has happened for a number of years in Australia with respect to monetary policy. Both major parties have effectively agreed to create a climate of predictability with respect to prices and interest rates. The payoff from monetary bipartisanship has been lower inflation for all Australians over the past 15 years. The payoff from emissions policy bipartisanship will be a stronger Australian economy.

Summary

Let me now quickly sum up the key points of what I have been saying.

We believe that open and realistic community discussion of the task in front of us can lead to an emissions trading model that many other nations can follow. There is much common ground between the Government and the BCA in relation to Australia's intention to address the climate change challenge. The BCA supports the Government's intention to introduce an emissions trading scheme, the CPRS.

Both the BCA and the Government agree that industry much assume part of the burden in doing this. However, both the Government and the BCA agree that some assistance will need to be given to EITEs and the electricity sector during the transitional period.

The BCA research reveals that the proposed assistance mechanisms as detailed in the Green Paper will produce a number of severe and unintended consequences. The BCA has proposed alternatives which will mitigate these impacts and achieve the intended objectives.

Depending on the price of carbon that is set and the speed at which we move towards the 2020 target - i.e. the emissions reduction trajectory that is set - it is likely that constraining assistance to EITEs at 20% of permit revenue will not prevent carbon leakage thus damaging the Australian economy and failing to achieve reductions in global emissions if the carbon differential between Australia and its competitor nations exceeds $20 per tonne.

However, as the Government rightly points out, every dollar or assistance it gives to EITE businesses that is one dollar less it has to give to consumers. Consumers are also voters. The higher the differential between the price of carbon in Australia and competitor nations, the greater the problem.

This is the grisly political problem for a government of any political persuasion I referred to at the beginning of this talk. There is a very real cost associated with

moving too far and too fast ahead of our global competitors. That is not to say that Australia should not do so. The extent to which we should do so is rightly a decision for the Government to make.

It must however be made in full recognition of the costs of doing so. It would be foolish to pretend that business, and in particular EITEs have some magic capacity to bear the costs of doing this. They do not. The BCA research shows clearly that faced with such a severe financial penalty they will simply migrate offshore with the loss of Australian jobs and investment with no reduction in global emissions. Such an outcome cannot be in anyone's interest.

The BCA has proposed two solutions which would both allow Australia to move to a more demanding emissions regime once a world carbon price was in place. Both solutions would retain all the fundamentals of the government's scheme – a scheme which is fundamentally well-designed.

The BCA believes that Australia must debate its intentions openly and honestly with full recognition of the costs involved and make its decision in the full knowledge of the costs that the community is prepared to accept.

To do otherwise will likely see us with a CPRS which both fails to achieve its objective and damages the Australian economy.

On the other hand done properly the CPRS can succeed and be a true role model for others to follow.

Business has a critical role to play in achieving just such an outcome and it wants to play that role

ENDS.