

14 September 2009

The Hon Andrew Robb AO, MP
Shadow Minister Assisting the Leader on Emissions Trading Design
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Business
Council of
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Dear Mr Robb

Further to my letter of 24 August 2009 I am pleased to share with you the views of the Business Council of Australia (BCA) on possible amendments to the proposed Carbon Pollution Reduction Scheme (CPRS). I have also written to Minister Wong and Senators Fielding and Xenophon with the same proposals.

The BCA would like to see amendments made to the CPRS which ensure that the scheme detail is right and that the implementation of the CPRS, in the absence of a global price on emissions, is in a manner that minimises the risks of economic shocks and unintended consequences such as job losses. A poorly designed CPRS will put future investment and economic growth at risk.

Working within this framework the BCA offers the following recommendations.

Arrangements for emissions-intensive, trade exposed-industries

Until such time as there is a consistent global price on emissions, recognition of the position of Australia's emissions-intensive, trade-exposed industries (EITEs) is essential to ensure the preservation of Australian jobs and to avoid 'carbon leakage', that is, where emissions-intensive Australian industries simply move to other countries or where the competitiveness of domestic producers is eroded leading to greater imports from non carbon - constrained countries.

The approach taken to EITE industries under the CPRS does not totally offset the impacts of the CPRS on the competitiveness of these industries. The inclusion of an annual reduction in permits available to these industries i.e. the 1.3% annual decay rate is an additional impost on these industries which will already be purchasing at a minimum 5.5% and 34% of permits subject to the activity definition.

In light of this the legislation should be amended to address the following matters:

- Given the approach being taken in the US negotiations and the unclear outcomes of the international negotiations the CPRS legislation should specify that EITE arrangements will operate at least till 2020 and that permit allocation can only be varied following a public review post 2020 on an activity-by-activity basis and with five years notice.

- Greater clarity and specificity is required on the test to be used for the varying of EITE arrangements. What remains essential is that the test should be a measure of the carbon price faced by Australian business competitors. One approach would be to require the review panel undertaking the five yearly review to have evidence at the activity level that 80% of relevant international trade competitors have adopted emissions reduction measures that in effect impose a comparable emission price on the products produced by the activity before a five year notice period was given for the varying of the EITE arrangements for that activity.
- The definition of an activity should recognise that where a product requires a number of integrated sequential and parallel processes in order to be produced, all those processes are included in the definition of the activity. A review mechanism should also be included in the legislation and available where there is a disagreement on the activity definition.
- The BCA believes the decay rate poses an increasing burden on EITEs and if maintained it must be time-limited. The decay rate should be removed no later than five years after the commencement of the scheme. It is also essential to provide mechanisms for companies to seek a review and exemption from its application. These matters are discussed in detail later in this document.
- There are a number of businesses which are profitable and operate on low margins. It is recognised that the use of revenue in calculating their eligibility for EITE arrangements is not appropriate and the option to use value add has been provided. However there are a number of ways of measuring value add. A definition of value add should be included in the Act which recognises all input costs (including repairs and maintenance) as possible deductions from revenue for the purposes of calculating value add. One such definition is that of industry value add as used by the Australian Bureau of Statistics (noting that there may need to be some simplification to cover deductions of insignificant non-consumable expenses)
- It should be noted there are a number of design elements of the CPRS which will have significant detrimental impacts for specific EITE operations eg the electricity allocation factor and the treatment of low-emissions demonstration plants. The BCA has not done detailed work on these matters in light of the analysis being undertaken by the directly affected companies.

The modelling of the CPRS (adjusted) by Frontier Economics provides a clear indication of the broader economic benefits of providing improved arrangements for the EITEs and coal sector – namely both a reduced impact on regional Australia and a lower impact on GDP over the time period.

The treatment of coal

The approach taken to coal mining under the CPRS is of concern to the BCA at two levels.

The first of these relates to the policy approach of “carving out” an activity that meets the threshold for EITE arrangements. It is important that the Act is drafted in such a manner that future eligible activities can not be excluded from EITE arrangements.

The second relates to the impact on the coal sector. The plan to include fugitive emissions from coal mines in the CPRS when neither the EU nor the US is doing this has the potential to impact on the competitiveness of our coal exports. What remains essential is to establish arrangements that ensure the competitiveness of this vitally important industry is sustained and jobs are not lost in the absence of a global approach to reducing greenhouse gas emissions. Options that could be considered include: providing EITE arrangements to coal mines on the basis of a measure which prevents windfall gains; excluding fugitive emissions from coal mining until they are included in other emissions trading schemes; and expanding the *Coal Mining Transitional Assistance Fund* in quantum and timing.

Scope 3 emissions

Given the government's current intention is not to provide assistance for Scope 3 costs, including emissions from coal, there is a need to ensure whatever arrangements are put in place for coal mining do not lead to an increased cost pass-through to those industries where coal is a key input.

The current proposal to provide coal mines with access to a very limited pool of funds to address emissions reduction will not, of itself, address the risk of cost pass-through. These funds are unlikely to offset all costs coal mines will face with the introduction of the CPRS, leaving coal mines to seek recovery via cost pass through to EITE customers who, in turn, will not receive any assistance for Scope 3 costs.

In light of this situation it is proposed that either the definition of feedstocks be expanded to include coal or inclusion in the Bill of an independent review mechanism where if it is found coal companies have passed, or sought to pass-through fugitive emissions costs to the steel industry the government will provide additional assistance to fully offset this cost.

Facilitating a smooth transition to a low emissions electricity sector

All businesses in the Australian economy, as well as households need access to reliable electricity. In light of this there is a need to ensure the smooth transition of the electricity sector to low-emissions technology. 85% of the energy in the Eastern States is from coal-fired generation today and that this will take time to transform. This proportion is in excess of 90% when considering Queensland, New South Wales and Victoria.

The final design of the CPRS must therefore provide coal-based generators with the capacity to supply electricity through the transition period, ensure access to international permits and also provide strong incentives for investment in low-emissions technologies in the sector, including the commercialisation of carbon capture and storage (CCS).

There is a need for transitional assistance which ensures there is not an adverse impact in the short to medium term on the electricity market.

The period of transition of 5 years proposed in the CPRS is too short. It does not accord either with the length of investments in power stations (25-40 years), or the timeframe necessary for commercialisation of applicable low emission energy technologies such as CCS.

There has been substantial modelling and analysis of the investment level required over the next decade to meet both the growth in demand for electricity and the need to move to less emissions-intensive supply.

There has also been recognition by government and others that coal-fired generators will be strongly affected following the introduction of the CPRS.

It is notable that the Government commissioned three separate models to assess the likely impacts on asset value that the CPRS may have on the sector. As the work recently undertaken by Frontier Economics noted, two of these models, (undertaken by ROAM Consulting and ACIL Tasman), reported losses over the first decade of \$9.4 billion and \$10.5 billion respectively. The third model (undertaken by MMA) suggested the asset value loss would be in the vicinity of \$2.3 billion. Previous modelling by MMA for the National Emissions Trading Taskforce had asset value losses at over \$10 billion up to 2020.

The current proposal is that \$3.5 billion be made available over five years, under the Electricity Sector Adjustment Scheme (ESAS), to coal-based electricity generators.

Both the time period and quantum of funds are not sufficient to provide the smooth transition. Investment decisions (both in existing and new infrastructure) are already being affected and large-scale impairments (debt and equity) are anticipated if the CPRS, as currently designed, remains.

The BCA is aware further work is now underway by Morgan Stanley to review the financial circumstances of the coal-fired generators. The BCA is of the view that this work should inform a revision of the size of the ESAS fund and that the financial assistance should be made available for a longer period.

Electricity generators will face substantially increased demands on their working capital requirements with the commencement of the CPRS. The government's white paper acknowledges this as an issue. In finalising the auction arrangements options should be pursued which address this issue such that there is not an adverse impact on the working capital requirements of the generators.

Improving policy outcomes

It is not the setting up of an emissions trading scheme of itself, but the investments and innovations made by business, which will help move Australia to a low-emissions economy. In this context a key concern for the BCA is the quality of the policy developed.

There are substantial benefits for Australia in the coalition and government working together to resolve the outstanding matters in the CPRS and providing greater certainty on the key elements of the CPRS.

Also as part of the process of improving policy predictability the BCA proposes that there be a number of policy matters explicitly included in the CPRS Bills rather than in regulation. The table below summarises these matters.

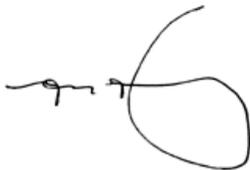
Determining Australia's emissions target	<p>The Act should detail the public review mechanism to be used for any movement from the unconditional 5% reduction.</p> <p>Such a review should include assessment of global action and the actions of Australia's competitors (at the activity level) to identify whether there is comparable action which is measurable, reportable and verifiable.</p> <p>The review should also include reference to the share the national target that will be met through the CPRS and the uncovered sectors.</p>
EITE Activity definition	The parameters for an EITE activity definition should be included in the Act. The definition of an activity should include all stages of a parallel or sequential activity ie where a product requires a number of integrated sequential and parallel processes in order to be produced, all those processes are included in the definition of the activity.
Review of activity definitions	An appeal mechanism should be included in the Act where a company can seek a review of the activity definition on the basis of the above parameters.
Fixed initial period of EITE arrangements prior to a review	The Act should include a clause which states that EITE arrangements will be in operation until 2020. The Act should also specify that the first review to determine whether EITE arrangements should be varied is after this date and that there should be five years notice of any variation to EITE arrangements.
Varying of EITE arrangements	<p>The Act should include a specific test for the varying of EITE assistance. The purpose of such a test is to ensure there is an assessment at the activity level as to whether the competitors to the Australian businesses have an equivalent carbon price.</p> <p>One approach would be to require the panel undertaking the five yearly review to have evidence at the activity level that 80% of relevant international trade competitors have adopted emissions reduction measures that in effect impose a comparable emission price on the products produced by the activity. Subject to the outcomes of the review a five year notice period would be given for the varying of the EITE arrangements for that activity.</p>
Notice period for varying of EITE arrangements	5 year notice period at a minimum must be given for the varying of EITE arrangements at the activity level.
Definition of value add for the purposes of calculating EITE arrangements	A definition of value add should be included in the Act which recognises all input costs as possible deductions from revenue for the purposes of calculating value add. One such definition is that of Industry Value Add (IVA) as used by the Australian Bureau of Statistics. We note that there may be a need for some technical simplifications to cover deductions of insignificant non-consumable expenses.
EITE arrangement thresholds	<p>The Act should include the thresholds for EITE identification and the permit allocations for each threshold as well as methods for calculation.</p> <p>This section of the Act should be drafted in such a manner that precludes the exclusion of activities which meet the threshold criteria from EITE arrangements.</p>
Decay rate	A time limit of 5 years should be set for any decay rate. The ongoing application of a decay rate, in the absence of a global carbon price, will make Australian businesses uncompetitive over time.

	<p>Grounds on which a company (for an activity) can seek a review of or exemption from the decay rate prior to the commencement of the scheme or during the operation of the scheme should be specified in the Act. These could include:</p> <ul style="list-style-type: none"> - where individual companies have already made the investments in: emission reducing technology the efficiencies to offset the decay rate may not be available; - where the technology or production process is as efficient as possible - where alternative technology investments are required to achieve emissions reduction and the decay rate impacts on the capacity to make the investment in a timely manner - where competitiveness will be increasingly affected the longer the decay factor applies.
Large electricity user contracts and reviews	The Bill should include a specific clause making clear the policy intention and the scope of the decisions the Authority must make in light of any review.

Finally for many businesses carrying out EITE activities there is substantial detail that is still not known and ultimately will be included in regulation. These matters include the specific activity definition and permit allocation. Business will need to see the detail of these matters for each of the EITE activities they carry out prior to the passage of any legislation. This is essential so businesses can plan for the implementation of the CPRS.

The BCA will be pleased to discuss these matters further with you.

Yours sincerely



Greig Gailey
President

Cc The Hon Malcolm Turnbull MP
Leader of the Opposition

The Hon Greg Hunt MP
Shadow Minister for Climate Change, Environment and Water

Senator the Hon Nick Minchin
Shadow Minister for Broadband, Communications and the Digital Economy