Energy Security Board National Energy Guarantee Draft Design Consultation Paper

submission

March 2018

Carbon Market Institute

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Executive Summary

The Carbon Market Institute operates at the interface of climate change policy and business in Australia. Independent and non-partisan, we're the peak industry body for climate change and business and we are dedicated to helping business seize opportunities in evolving carbon markets. We believe that market-based approaches are the most efficient policy mechanism to address the challenge of climate change.

The Energy Security Board (ESB) has released a consultation paper on the National Energy Guarantee (NEG). The NEG aims to provide a legislative framework for the National Electricity Market (NEM) to address the need for reliable, secure and affordable electricity. This is to be achieved through two specific guarantees; a reliability guarantee and an emissions guarantee.

The ESB is seeking high level feedback on these two draft design elements of the NEG, the outcomes of which will be presented to the Council of Australian Governments (COAG) Energy Council in April 2018 to inform the detailed design of the NEG.

We acknowledge the ESB's role in providing a robust legislative framework to meet Australia's energy needs and a framework that will transition the energy sector to lower emitting generation sources. It is critical that the development of the NEG considers Australia's current climate change policy and long-term emissions reduction objectives to ensure the effectiveness, stability and predictability of the domestic policy framework.

Our international targets, set by Australia as part of our commitment under the Paris Agreement, of a 26-28 per cent reduction on 2005 levels by 2030 will require below business as usual emissions reductions. The ESB must make clear how the design elements of the emissions requirements in the NEG will specifically contribute to achieving our 2030 emissions reduction target as proposed in Australia's Nationally Determined Contribution (NDC) under the Paris Agreement.

It is important to take into account that these emissions reduction commitments under the Paris Agreement are a floor, as the targets will be reviewed and strengthened in line with a formal Global Stocktake process that countries agreed to in Paris. Australia's energy sector will need to shoulder its fair share of these commitments and the development of an effective policy framework should outline how the energy sector will enhance its emissions reduction commitments and increase its ambition as our Paris Agreement targets scale up over time.

There is widespread recognition in the business community that domestic policy settings will have to tighten in the near future, and that this will inevitably include a form of emissions trading and a carbon price signal. Achieving a net-zero carbon economy by 2050 will require the energy sector to play its role whilst acknowledging that other sectors must also contribute to the abatement task. The final design of the NEG should clearly indicate how current climate policy – specifically the Safeguard Mechanism – will interact with the emissions guarantee design so as to stimulate, in a transparent manner, the necessary abatement activity and investment in clean energy that will ultimately decarbonise the energy sector.

This submission summarises CMI's position. The recommended principles and factors to consider outlined below build on our extensive 2017 climate policy review consultation undertaken with our members, and domestic and international experts, as well as subsequent ongoing engagement and consultation with members regarding the NEG.

The following submission comprises the guiding principles framing our position; a summary of policy options, considerations and recommendations; and a more detailed discussion on each of these key points.

The executive summary and subsequent discussion represents a synthesis of member views and is not representative of any individual or CMI member company position.

Guiding Principles

In developing this submission, CMI has been guided by a series of principles. These are:

- Australia's national emissions reduction target should be in line with the global response to the threat of climate change to keep temperature rise this century **well below 2 degrees Celsius** above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5 degrees Celsius. The Government should confirm a long-term goal of an economy wide zero-net emissions target.

- The Carbon Market Institute views a **market-based approach** to emissions reduction as providing an effective and efficient framework to meet emissions reduction goals and challenges at lowest cost. The primary policy instruments to reduce emissions across the economy should involve emissions trading and putting a **price on carbon**.

- Australia's policy suite should be **comprehensive and enduring** to create a stable and predictable policy landscape for business; and climate policies should be reviewed at predetermined intervals again in line with UNFCCC commitments and evolving market conditions.

- Policies designed to reduce emissions from the energy sector and large emitters should be **aligned with the trajectory** required to meet current and future international targets which are likely to be set at more ambitious levels.

- To meet emissions reduction targets at lowest cost to the economy, Australia should open opportunities to **link and trade with international markets**.

The ESB and Government should ensure that the interaction of the NEG emissions guarantee with the Emissions Reduction Fund (ERF) and Safeguard Mechanism (as the Governments stated primary mechanisms to reduce emissions) are clearly defined and have the flexibility to evolve and engender bipartisan support. This will be central to alleviating uncertainty; obviating the need to overhaul or repeal existing policy; and ensuring an effective, stable and enduring policy environment.

This submission provides options, considerations and recommendations under three broad categories:

- The energy sector's contribution to Australia's international emissions reduction commitments
- International carbon market developments and the use of offsets
- Alignment of domestic energy and climate policy

It is under the above paradigms that CMI has formulated the following submission to the 2018 consultation paper on the draft design elements of the National Energy Guarantee.

Summary of Policy Options, Considerations & Recommendations

In this submission we have not presented a position on the reliability guarantee and have focused our response on the emissions guarantee component of the NEG.

Australia's International Emissions Reduction Commitments

1. The NEG emissions guarantee target should be **aligned to Australia's international commitments** under the Paris Agreement and play an active role in **reducing absolute emissions** in the sector.
2. The key components of Australia's market-based **energy and climate policy frameworks should be aligned** and designed to achieve long-term emissions reduction goals beyond 2030 that leads to a **net-zero emissions economy by 2050**.

Offsets and International Carbon Markets

3. If Australia is to reduce absolute emissions across the economy**, the potential use of domestic and international offsets have an important role to play** in the NEG to provide flexible compliance options.
4. **Understanding the rules of international markets** as they emerge under Article 6 of the Paris Agreement will be important to inform the potential **use of international units as a compliance option** under the NEG.
5. Supply of Australian Carbon Credit Units (ACCUs) requires creating a **viable secondary market and long-term contracts** for Australia's domestic abatement suppliers.

Alignment of Domestic Energy & Climate Policy

6. The electricity sector should **contribute its fair share of emissions reduction activity** if Australia is to meet its long-term emission reduction goals, and **the interaction of the Safeguard Mechanism and the NEG emissions guarantee** will need to be clarified.
7. A **stable, enduring policy environment is needed** in Australia as the importance of **managing climate change risk** is increasingly important for Australia's competitiveness in the global economy.

Australia's International Emissions Reduction Commitments

1. **The NEG emissions guarantee target should be aligned to Australia's international commitments under the Paris Agreement and play an active role in reducing absolute emissions in the sector.**

   As part of its Nationally Determined Contribution (NDC) submitted under the Paris Agreement, the Australian Government committed to an emissions reduction target of 26 to 28 per cent below 2005 levels by 2030[1]. Under this commitment Australia needs to reduce absolute emissions across the economy, below business as usual.

   The Paris Agreement formalizes a Pledge and Review mechanism whereby NDC targets are to be reviewed every five years (commencing in 2023). With each revision, countries (Parties) will have the option to maintain their existing target or increase the level of ambition. The global pressure to increase ambition and the Pledge and Review mechanism will mean Australia, and other countries, will likely come under pressure by the international community to commit to greater emissions reduction targets.

   Under the NEG emissions guarantee, the Government's proposed target for the electricity sector is a 26 per cent reduction below 2005 levels by 2030. In line with this commitment, the Government is seeking to develop an emission trajectory under the NEG that would provide retailers with an annual emission target per MWh.

   In setting the emissions target under the guarantee, the Government should consider how individual retailer targets will drive down absolute emissions in the generation sector. Under the NEG's proposed approach, emissions per MWh would self-adjust based on demand. Meeting the emissions reduction trajectory for the sector would therefore depend on total electricity demand. The emissions guarantee's focus on emissions intensity of the power retailers sell, may result in absolute emission from the sector increasing if overall power demand increases. In the event that increases in demand are out of step with annual retailer targets, absolute emissions reduction in the sector can not be guaranteed.

   Achieving emissions reduction in the energy sector will therefore require an abatement trajectory that factors in Australia's international commitments, drives investment in cleaner generation sources and has a measurable absolute emissions reduction goal. Ultimately the NEG must be designed so it sends an explicit carbon price to drive down absolute emissions in the electricity generation industry.

2. **The key components of Australia's market-based energy and climate policy frameworks should be aligned and designed to achieve long-term emissions reduction goals beyond 2030 that leads to net-zero emissions economy by 2050.**

   For the energy sector to play its role in supporting Australia's global emissions reduction commitments under the Paris Agreement, the Government should first consider and define the long-term emissions reduction goal for Australia beyond 2030 that leads to an end goal, being a net-zero emissions economy by 2050. The targets set under the emissions guarantee for the electricity sector must be informed by this long-term zero-net emissions goal and be the impetus to decarbonise the sector.

[1] Commonwealth of Australia, Department of the Prime Minister and Cabinet, Setting Australia's post-2020 target for reducing greenhouse gas emissions. Final report of the UNFCCC Taskforce

Implementation of a long-term 2050 net-zero emissions reduction target provides business with the certainty required to make necessary investments in clean energy, infrastructure and technology innovation that will reduce emissions across the domestic economy. Australia should look to long-term targets set by countries such as the United States, Canada and Germany who have all outlined ambitious long-term targets for 2050[2].

Both Australia's NDC and a 2017 climate policy review commitment to "start developing a long-term emissions reduction strategy by 2020"[3] highlight the importance of setting this long-term target. Knowing the end goal and timeline for achieving zero-net emissions will help frame the policy trajectory for the emissions guarantee and give investors and owners of energy infrastructure a framework under which to manage an orderly low carbon transition.

The design of the emissions guarantee under the NEG must therefore not only achieve the electricity sectoral target proposed but establish a policy framework that will allow continued and absolute reductions from the sector over time. With a well-designed, effective and long-term policy suite, Australia can provide a stable landscape for business decision making and navigate the low emissions transition in line with our international commitments.

[2] Germany, through its Climate Protection Plan 2050 has indicated it will put in place measures to achieve a net-zero emissions economy by the half way point of the century. Both the United States and Canada have in place targets of 80 percent reductions on 2005 levels by 2050.

[3] 2017 Review of Climate Change Policies, Australian Government Department of the Environment and Energy, December 2017.

Offsets and International Carbon Markets

3. If Australia is to reduce absolute emissions across the economy, the potential use of domestic and international offsets have an important role to play in the NEG to provide flexible compliance options.

The use of domestic and international offsets should be included as a flexible compliance option under the NEG if Australia is to meet its long-term absolute emissions reduction targets. Under the NEG, allowing emissions to adjust based on demand leaves opens the possibility of an increase in absolute emissions from the sector if demand increases. In this scenario, offsets can act as a 'safety valve' and provide an additional avenue for increasing emission guarantee targets to be met, whilst concurrently driving broad-sector abatement in the economy.

The NEG proposes that retailers could be allowed to use eligible offsets as a flexible compliance option to meet a proportion of their emissions target. Offsets can provide a cost-effective way of reducing emissions in the economy and provide a clear market signal for investment in emissions reduction activity. It is important that policy frameworks in the electricity sector have the flexibility to access low-cost, high quality abatement from both domestic and international sources, if they are available.

The Australian Government's Emissions Reduction Fund (ERF) is an established framework in Australia that can be used to generate domestic credits. The ERF has played a valuable role in supporting continuity of demand for domestic abatement, in the transition from the Carbon Farming Initiative. The ERF has catalysed the development of a suite of emissions reduction projects, and has preserved and supported the deep expertise that now exists in the Australian offset market.

It is important that the Government seeks to understand what the demand for offsets under the emissions guarantee target would look like and where the supply will come from. Access to low cost, quality abatement will become increasingly important as Australia's emissions reduction task grows. Undertaking research to model the future supply and demand of domestic and international abatement under different scenarios is imperative to support and inform policy decisions around the use and eligibility of offsets.

The ESB should also be informed by the Government regarding the eligibility criteria of offsets from international markets that could potentially be used by retailers to meet their emissions guarantee. As part of the 2017 Climate Policy Review, the Government provided in-principle support for the use of high quality international offsets under the Paris Agreement to meet emission reduction targets, and that consideration of any updates to rules and regulations under the Safeguard Mechanism, in the context of when and how international units can be used and under what conditions, would be taken in a review by the end of 2020. Having alignment of eligible offsets across both Australia's climate policy and energy legislation would support a functioning marketplace for domestic abatement and linkage of international markets.

It will be important to achieve the right balance of international abatement and domestic abatement for ensuring continuity of demand and protection of the domestic abatement sector, while ensuring abatement costs can be managed. The Government should provide clarity on how the balance of international and domestic units can be determined and what quantitative and qualitative restrictions are important for maintaining a domestic abatement industry and the international competitiveness of Australian business.

Globally, climate policy is continuing to evolve and increasingly countries are implementing market-based mechanisms to address climate change. This includes some of Australia's key trading partners, namely China, South Korea, the European Union, New Zealand and major provinces in the Unites States and Canada.

The use of domestic offsets in many of these international schemes is a key design element; it is used as an effective means of contributing to the emissions reduction task; and provides flexible compliance options for covered entities. For example, the US Regional Greenhouse Gas Initiative (RGGI), which covers the energy sector across 9 US sub-national jurisdictions, allows the use of domestic offsets to meet a portion of the emissions requirement under the RGGI cap-and-trade program. The policy frameworks developed under the NEG should be informed by these international schemes.

As the rules under the Paris Agreement continue to evolve, the use of international units is becoming increasingly relevant. In fact, more than 90 countries have outlined the use of international markets in their NDC as a mechanism to achieve their emissions reduction targets. Building capacity in Australia's existing domestic offset scheme by allowing offsets to play a role in the NEG emissions guarantee design would further strengthen Australia's preparedness to participate in these international carbon markets. Understanding the rules of international markets as they emerge under Article 6 is discussed further in section 4 of this submission.

Allowing the use of offsets to meet the emissions guarantee targets under the NEG would provide an important market signal to drive investment in new domestic abatement activity and increase certainty around the long-term supply of credits into the market.

4. Understanding the rules of international markets as they emerge under Article 6 of the Paris Agreement will be important to inform the potential use of international units as a compliance option under the NEG.

At the time the proposed NEG emissions guarantee becomes effective in 2020, the availability and price of international units will be very different from the current market availability and price. The supply, demand and price of the proposed use of international units will change post 2020.

Understanding the dynamics of international trade in carbon will be critical in developing the policy for the NEG. There is a common perception in Australia that cheap international units will be around forever. The future availability and price of international units is however, uncertain, and there is unlikely to be an endless supply of cheap international units in a post-2020 environment. There are over 90 countries that plan to access international markets to meet emissions targets, and Australia would increasingly compete with demand from other countries hoping to access international units (in addition to soaking up their own domestic supply) to meet their NDC targets.

Article 6 of the Paris Agreement contains key market provisions that are expected to be the guiding framework for international carbon market activity and trade in emissions going forward. The ESB and Government will need to be informed on the details contained within Article 6 as the development of the Paris Rulebook is expected to be completed by December 2018.

The emergence of new net-buyers in the Indo-Pacific (and globally), and the transition to the new market mechanisms post-2020 under the rules being written for Article 6 of the Paris Agreement, mean that the opportunity to purchase high-quality, low-cost abatement is likely to be a short-term one.

Any modelling to be done under the NEG and for compliance purposes (and for the Safeguard Mechanism) should include modelling of the factors that affect availability, future supply/demand, and price for domestic and international units as countries implement their Paris Agreement commitments. Although the government has signalled in its 2017 climate policy review that it has given in principle agreement for the use of international units, Australia currently does not have a policy to use these units in our compliance markets.

The NEG proposes that retailers could be allowed to use eligible offsets as a flexible compliance option to meet a proportion of their emissions target. It is important that the policy framework in the electricity sector has the flexibility to access low-cost, high quality abatement from international sources, if they are available.

The ESB should be informed by the Government regarding the eligibility criteria of offsets from international markets that could be used by retailers to meet their emissions guarantee. Furthermore, the ESB should work with the Government to determine the eligibility criteria for use of international units before 2020, so that liable entities (including emitters and retailers) can access lowest cost abatement options before they experience likely scarcity and/or higher-cost abatement post-2020 (which would affect offsets as an option to manage flexible compliance and associated costs). Having alignment of eligible offsets across both Australia's climate policy and energy legislation before 2020 would support a functioning marketplace for domestic abatement and potential linkage of international markets in the future.

It will be important to achieve the right balance of international abatement and domestic abatement to ensure continuity of demand and protection of the domestic abatement sector, while ensuring abatement costs can be managed. The Government should determine how the balance of international and domestic units can be determined and what quantitative and qualitative restrictions are important for maintaining a domestic abatement industry and the international competitiveness of Australian business. The Australian Government should continue to engage in international/bilateral/regional fora so that it can be part of the rule-making process, and not be a rule-taker. It is also important that Australian business has a 'window' into the dialogues about the mechanics of future global carbon markets, so that it is well positioned to benefit from these markets in the future.

5. Supply of Australian Carbon Credit Units (ACCUs) requires creating a viable secondary market and long-term contracts for Australia's domestic abatement suppliers.

If ACCUs are to be used under the NEG there needs to be a deep, viable, liquid secondary market for ACCUs, which currently doesn't exist. Almost all the supply of ACCUs are tied up in government ERF contracts. There needs to be significant investment in the supply of ACCUs to ensure there is an ongoing supply of domestic credits - especially as private sector demand from other sources is set to increase - otherwise the cost for compliance will increase significantly above the price the Government is paying for credits under the ERF.

A strong price signal from energy policy and the establishment of long-term offtake contracts will be essential to drive investment in domestic offsets. Under the assumption that demand for domestic units under the NEG and the Safeguard Mechanism will increase in a post-2020 environment (enabling a transition to private sector funding of abatement) it is important there is continued investment in the factors that will ensure the growth of the domestic carbon market.

Alignment of Domestic Energy & Climate Policy

6. The electricity sector should contribute its fair share of emissions reduction activity if Australia is to meet its long-term emission reduction goals, and the interaction of the Safeguard Mechanism and the NEG emissions guarantee will need to be clarified.

Australia's electricity sector represents 35% of Australia's emissions inventory[4] and should shoulder its fair share of Australia's long-term emission reduction goals. In developing the design elements of the emissions guarantee, the ESB and Government should consider how the emissions reduction trajectory gives appropriate weighting to the sector in the context of Australia's international commitments.

The policy framework needs to create an environment where emissions from across the economy decline over time and allow the transition to a low-carbon economy at lowest cost. The Government's target for the electricity sector is a 26 per cent reduction below 2005 levels by 2030. Whilst this is consistent with the national target, the Government should assess whether this proportional approach to setting the target is the most cost-effective way to meet Australia's emissions reduction objectives. An assessment of the impact on the emissions reduction burden on other industrial and commercial sectors will be necessary so as to not disproportionately disadvantage sectors where emissions reduction actions comes at a greater cost than the electricity sector.

The Safeguard and the NEG, with domestic offset supply from the ERF should be the primary climate and energy policy mix to do the heavy lifting and drive down absolute emissions to 2030 and beyond. However, it is not clear how the Safeguard Mechanism and the NEG will interact. A well-designed alignment of complementary climate and energy policies should incentivise investment in abatement projects and stimulate emissions reduction activity across the economy.

The electricity sector is currently subject to a sectoral baseline under the Safeguard Mechanism. Under the NEG, the onus is placed on retailers to meet individual emissions targets (emissions per MWh) through contract arrangements with generators. The Government's Safeguard Mechanism could evolve in a complementary way so it becomes effective in limiting and reducing emissions from liable entities without legislative change (through the adjustment and ratcheting down of baselines).

Ensuring alignment of the emissions guarantee in the NEG and evolution of emissions baselines under the Safeguard Mechanism is important to provide certainty for all sectors covered under these policies. Importantly the ESB and Government should provide clarity as to how the suite of climate and energy policies together will address the emissions reduction contribution of the electricity sector to Australia's existing and future emissions reduction commitments.

Additionally, Australia's treatment of EITEs under the NEG should be informed by developments in global markets, where carbon pricing policies and broad-sector emission trading schemes continue to evolve. The EU and California have set clear objectives in their policies for the level of transitional assistance received by the industrial sectors and importantly, how this assistance will decline over time. Australia's policy framework must recognise that an efficient and effective transition is required to meet Australia's long-term emissions reduction targets.

[4] Quarterly Update of Australia's National Greenhouse Gas Inventory: September 2017

7. **A stable, enduring policy environment is needed in Australia as the importance of managing climate change risk is increasingly important for Australia's competitiveness in the global economy.**

   Since the recommendations of the industry-led Taskforce on Climate-Related Financial Disclosures (TCFD) were released, the business community and investors have placed increasing importance on managing climate related risks. Established by the Financial Stability Board (FSB), the TCFD recommendations have provided a consistent framework for companies to disclose their climate-related financial risks. The TCFD climate disclosure model has been widely supported by Australia's largest entities, and many have already disclosed scenario analyses in their company publications in line with the TCFD recommendations.

   Australia's policy environment should provide long-term certainty to business and investors across the economy. The boards of Australia's largest companies are increasingly recognising that addressing the potential financial impacts of climate change is key to managing material business risks. The NEG has a role to play in shaping energy policy and driving the decarbonisation of the energy sector. Developing a legislative framework that addresses Australia's international emissions reduction commitments and aligns to current climate policy can provide a more stable and predictable landscape for business. In an environment where the global energy system is transforming, effective policy decisions can act as an enabler for an economically secure energy future.

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The Carbon Market Institute is at the centre of climate change policy and business in Australia. Independent and non-partisan, we bring business, policy makers and thought leaders together to drive the evolution of carbon markets towards a significant and positive impact on climate change.

Engaging leaders, shaping policy and driving action, we're helping business to seize opportunities in the transition to a low carbon economy.

Carbon Market Institute