

15 Transitional issues

The introduction of the Carbon Pollution Reduction Scheme (the Scheme) will be a major economic reform that will have widespread economic consequences. Several issues require consideration in the lead-up to, and following, the introduction of the Scheme.

This chapter addresses four issues associated with the transition to the Scheme:

- Section 15.1 discusses the termination of two existing state-based schemes operating in the electricity market.
- Section 15.2 describes possible measures to provide credit for early abatement action and the need for such measures.
- Section 15.3 considers whether specific measures are needed to address carbon cost pass-through.
- Section 15.4 assesses the advantages and disadvantages of a fixed-price transition period.

15.1 Termination of existing measures

The Green Paper noted that two major state-based greenhouse gas reduction measures operate in the electricity market—the New South Wales (NSW) and Australian Capital Territory (ACT) Greenhouse Gas Reduction Scheme (GGAS) and the Queensland Gas Scheme.

GGAS began on 1 January 2003 and was originally scheduled to operate until 2012. On 8 December 2006 the *Electricity Supply Amendment (Greenhouse Gas Abatement Scheme) Act 2006* (NSW) came into effect, extending GGAS until 31 December 2021 and beyond, subject to possible national policy developments. The aim of GGAS is to reduce greenhouse gas emissions associated with the production and use of electricity in NSW from 8.65 tonnes of CO₂-e (carbon dioxide equivalent) per capita in 2003 to 7.27 tonnes of CO₂-e per capita by 2007, and to maintain that level.

The Queensland Gas Scheme commenced on 1 January 2005 and is scheduled to operate until 2020. Under this scheme, Queensland electricity retailers and other liable parties are required to source at least 13 per cent of their electricity from gas-fired generation. The Queensland Government subsequently revised the 13 per cent target to 15 per cent by 2010 and up to 18 per cent beyond 2010. Gas-fired generators in Queensland are able to create certificates for every megawatt-hour of electricity that they produce.

The Queensland Gas Scheme aims to diversify the state's energy mix, encouraging greater use of gas and the development of new gas sources and infrastructure in Queensland. An associated benefit is the reduction of greenhouse gas emissions from the Queensland electricity sector.

Green Paper position

State and territory governments are encouraged to discontinue their market-based programs once the national scheme commences, as this is consistent with the Council of Australian Governments' complementary measures and streamlining agenda. The Government will continue to work cooperatively with the New South Wales, Australian Capital Territory and Queensland governments to assist them in their development of appropriate transitional arrangements.

15.1.1 Multiplicity of schemes

The introduction of the Scheme provides an opportunity for all governments to assess the necessity of related policy measures, with a view to ensuring economic efficiency and streamlining the number of schemes in operation in Australia.

The Australian and state and territory governments have agreed to review existing policies and programs, assessing complementarity using a set of agreed principles. Those principles, which are also relevant to the GGAS and the Queensland Gas Scheme, are discussed more broadly in Chapter 19.

In response to the Green Paper, stakeholders generally supported the termination of existing market-based schemes. However, some were worried about the effect on investments made based on existing schemes:

Transitional or complementary measures should only be introduced or maintained where the [scheme] cannot deliver the proposed policy objective ... BP fully supports both the Commonwealth and the States through COAG in their efforts to review existing measures and remove those that duplicate the intent of the [scheme]. This is an essential step to reduce the compliance burden for industry and ensure that legislation is fit-for-purpose. (BP Australia, Submission 355, p. 17)

[Energy Australia is] concerned about the growth in greenhouse reduction and energy efficiency schemes ... any alternative schemes need to be national in scope and truly complementary. Clear termination or transition paths must be developed for existing schemes as a direct element of [the Carbon Pollution Reduction Scheme]. (Energy Australia, Submission 339, p. 2)

As a major participant in both GGAS and [the Queensland Gas Scheme], Origin has a keen interest in the transitioning arrangements for those schemes. We broadly agree with the statements made in the Green Paper in relation to these schemes. From an investment perspective most projects undertaken under either GGAS or [the Queensland Gas Scheme] are unlikely to be adversely impacted if these schemes are discontinued as the [Carbon Pollution Reduction Scheme] price signal is incorporated into market prices. The caveat on this statement is that a 'soft start' to the [scheme], with a weak price signal, would raise concerns about cancelling the existing schemes. For this reason, Origin agrees that the state schemes should logically be discontinued once the [national scheme] commences. (Origin Energy, Submission 815, p. 99)

The Australian Government considers that GGAS and the Queensland Gas Scheme are not complementary to the Scheme and that their continued operation would result in an increased

compliance burden on business and increased costs to the economy. In the interests of economic efficiency, and to reduce the number of schemes in operation in Australia, the Government supports termination of those schemes. However, the Government also recognises that it is the responsibility of the relevant jurisdictions to make decisions about the operation, and eventual termination, of those schemes.

15.1.2 Queensland Gas Scheme

The Green Paper noted that, while the Queensland Gas Scheme was not necessarily incompatible with a national cap and trade scheme, both schemes were likely to promote the use of gas, and the Government would need to carefully consider the interaction of the schemes to avoid imposing unnecessary costs on the economy.

The Queensland Government has made no decision to halt the Queensland Gas Scheme on the introduction of a national emissions trading scheme. In its submission in response to the Green Paper, it indicated that it would seek to transition the Queensland Gas Scheme into the national Scheme as soon as practicable:

The Queensland Government will work closely with the Australian Government to develop appropriate transitional arrangements once the interim and medium-term national emissions reduction targets are announced, and once it is satisfied that the objective of the gas scheme will be efficiently serviced through the [national scheme]. It is likely that when the benefits of the [Carbon Pollution Reduction Scheme] are broadly equivalent to that of the 18 per cent Gas Scheme, the [Carbon Pollution Reduction Scheme] will be the main mechanism driving new investment in gas fired generation in Queensland. At this time, the Queensland Government will consider transitioning out of the Gas Scheme to the [national scheme]. (Submission 518, p. 19)

Comparatively few stakeholders commented on the Queensland Gas Scheme. Among those arguing for its continuation were Ergon–Energex (Submission 369, p. 10) and Babcock & Brown Power (Submission 488, p. 19), who noted that participants with significant exposure could be adversely affected. Furthermore, they argued that the transitional process should be transparent to minimise any adverse financial or investment impacts on market participants and that transition should recognise investments made in good faith. Some stakeholders also noted the role of gas as a transitional lower-emissions fuel for electricity generation and argued that the cessation of the Queensland Gas Scheme would lessen the incentive for development of gas infrastructure. (QLD Gas Generator Forum, Submission 432; Arrow Energy, Submission 321).

However, other stakeholders supported the termination of the Queensland Gas Scheme, noting that most projects undertaken under it were unlikely to be adversely affected if it ended, as the national Scheme price signal is incorporated in market prices (Origin Energy, Submission 815, p. 99). However, the effect of termination would depend on the price signal of the Scheme.

The Australian Government has an interest in ensuring that unnecessary additional measures are phased out as soon as possible—the Queensland Gas Scheme is likely to be inconsistent with the complementary measures principles currently being considered by the COAG Working Group on Climate Change and Water. While a decision to end the Queensland Gas

Scheme is a matter for the Queensland Government, the Australian Government believes the Queensland Gas Scheme should be terminated at the earliest opportunity.

Policy position 15.1

The Australian Government will continue to work with the Queensland Government to encourage the development of appropriate termination arrangements for the Queensland Gas Scheme.

15.1.3 Greenhouse Gas Reduction Scheme

The NSW Government has previously concluded that GGAS and a national cap and trade emissions trading scheme should not operate in parallel. In December 2006, the *Electricity Supply Act 1995* (NSW) was amended to enable GGAS to be terminated if NSW participates in a national emissions trading scheme that will achieve greenhouse outcomes at least as stringent as those of GGAS. In the ACT, the *Electricity (Greenhouse Gas Emissions) Act 2004* (ACT) was similarly amended in November 2007. The NSW Government also released a consultation paper, *Transitional arrangements for the NSW Greenhouse Gas Reduction Scheme* (the GGAS Consultation Paper), in April 2008. The paper canvassed transitional issues for each rule and for NSW Greenhouse Gas Abatement Certificates (NGACs) that were unused at the end of GGAS.

In contrast to the national cap and trade Scheme, GGAS is a baseline and credit scheme. It requires individual electricity retailers and certain other parties who buy or sell electricity in NSW to meet mandatory benchmarks based on the size of their share of the electricity market. The benchmarks can be met by surrendering NGACs, each of which represents one tonne of CO₂-e that has been abated (that is, a reduction in emissions, measured against a baseline). The ACT has a counterpart scheme, which mirrors GGAS.

Four rules define how NGACs are created:

- The *generation rule* allows a generator to create NGACs where it generates electricity at a lower emissions intensity (for example, through the use of renewable or gas-fired generation) than the NSW pool average. The rule also rewards coal-fired generators that reduce their emissions intensity, measured against prior performance (that is, against a baseline).
- The *demand-side abatement rule* rewards projects for more efficient use of energy on the consumer side (for example, projects that install compact fluorescent light bulbs or replace electricity with gas), where that will result in lower greenhouse gas emissions.
- The *carbon sequestration rule* (relating to forestry) credits the estimated net increase in carbon stored in eligible forests.
- The *Large User Abatement Certificates (LUACs) rule* covers abatement activity by large electricity users that is not directly related to electricity production or consumption, such as reductions in industrial process emissions or energy-efficiency measures that improve the efficiency of gas use.

The Green Paper noted that for a project to be made worse off by the introduction of the Scheme and the termination of GGAS, the financial returns to the project would have to be less than would have been achieved if GGAS had continued in the absence of the national Scheme. Furthermore, until it was extended—conditional on NSW participation in a scheme that had or would be established (either nationally or in NSW and at least one other state or territory)—projects established under GGAS were only guaranteed that GGAS would be in existence until 2012. The assessment of project impacts should also take this into consideration.

In response to the Green Paper, the NSW Government noted:

[A] smooth transition is critical to protect the legitimate business interests of scheme participants, minimise avoidable impacts on NGAC and [national scheme] permit markets, and maintain incentives for abatement projects in the transition to the [scheme]. (Submission 903, p. 23)

Most stakeholders commenting on GGAS expressed similar views. Some stakeholders claimed that a number of project proponents and categories of GGAS participants would be made worse off.

The Australian Government has carefully considered these matters and has concluded that the bulk of projects entered into under GGAS will not be adversely affected by its cessation and the start of the Scheme. Specifically, the Government considers that there is no case for providing any assistance for the following classes of project:

- *Projects under Category A of the GGAS generation rule.* These projects entered into power purchase agreements with electricity retailers under a previous NSW voluntary benchmark scheme and were carried forward into GGAS. While there will be a loss of NGAC revenue, abatement as a result of these projects cannot be attributed to GGAS and the Australian Government does not consider that transitional arrangements are necessary for them
- *Projects creating LUACs.* Some stakeholders claimed that returns on investments in abatement projects creating LUACs, such as reductions in industrial process emissions or energy-efficiency measures that improve the efficiency of gas use, might not be realised by 2010. However, LUACs could never be traded—they could only ever be used against a party's own liability. When GGAS ceases, so does the liability, so a party could not be made worse off as a result of this transition. Furthermore, entities that have undertaken such abatement activities will benefit from having a lower liability under the Scheme
- *Lost NGAC revenue from energy-efficiency projects.* Energy-efficiency projects will not be able to create credits under the Scheme as they can under GGAS. Few stakeholders commented on this category. The NSW Government is considering arrangements to include existing energy-efficiency project accreditations in its planned NSW Energy Efficiency Trading Scheme
- *Forestry projects under the carbon sequestration rule.* GGAS sequestration providers are likely to be able to opt into the Scheme to continue to earn permits for net increases in carbon stocks. Once GGAS ends, forestry projects will still retain permanence obligations (there is a one hundred year minimum level of permanency required for continued storage of carbon). The NSW and ACT governments will allow these participants to either buy

back NGACs and acquit any liability for permanence or to opt in to the Scheme with a corresponding liability if sequestration is not maintained.

Projects that may be adversely affected by GGAS termination and national Scheme commencement

The Australian Government considers that three categories of GGAS participants may be adversely affected by the termination of GGAS:

- *Landfill gas and waste coal mine methane generation projects (Category D).* Proponents of some of these projects claimed that they would not be able to capture a sufficient proportion of the benefits associated with their activities to offset the loss of their income stream from selling NGACs. GGAS rewards these generators for destroying methane, which is a more powerful greenhouse gas than carbon dioxide. Proponents of these projects also receive revenue from electricity generation.

Under the Scheme, there will still be strong incentives to destroy methane, although the generator might not be able to capture all of the associated benefits. This is because the Scheme penalises the coal mine or landfill (once the emissions from that landfill are covered by the Scheme) for emitting methane. By supplying gas to the generator rather than emitting that gas directly to the atmosphere, the coal mine or landfill reduces its liability to surrender permits under the Scheme. The coal mine or landfill will not necessarily pass on all of the benefits from its reduced liability to the company generating electricity by burning the gas, which will no longer receive NGAC revenue.

However, subject to contractual arrangements, coal mine methane and landfill gas generators will benefit from increases in electricity prices as a result of the Scheme. In addition, some landfill gas projects will receive revenue under the expanded national Renewable Energy Target as renewable energy generators. These factors could ameliorate the effect of lost NGAC revenue.

- *Holders of unused certificates at the time that the Scheme commences.* Once the Scheme begins, unused NGACs will become worthless, unless they have value in the voluntary market.
- *Cogeneration projects.* A small number of proponents of these projects claimed that they might not receive the same incentive under the Scheme as they do under GGAS. It is highly unlikely that any cogeneration project will be rendered uneconomic as such projects will be implicitly rewarded under the Scheme, which will increase the price of other power sources. However, some cogeneration projects currently receive NGACs for avoiding methane emissions via the diversion of putrescible waste from landfill, for which they would not receive benefit under the Scheme. The Government considers that these projects may be adversely affected by the termination of GGAS.

NGAC revenue for the period after 2012

A number of project proponents argue that consideration should be given to NGAC revenue for the period to 2020, claiming that they acted on assurances from the NSW Government. Some stakeholders claimed that they acted on direct assurances that GGAS would continue to operate, prior to a commitment to a national Scheme. For instance, Visy noted:

Direct assurances by the NSW Government that the GGAS would be extended to 2020 must be honoured because investment decisions were made, and developments are on foot, based on these assurances. (Submission 437, p. 16)

As evidence for claims that the Australian Government should consider lost NGAC revenue to 2020, a number of submissions referred to assurances in the second reading speech on the Electricity Supply Amendment (Greenhouse Gas Abatement Scheme) Bill 2006 (NSW). However, the second reading speech, available on the NSW Parliament website <http://www.parliament.nsw.gov.au>, reiterated the conditional nature of the extension:

The New South Wales Government has called for national leadership from the Commonwealth in ratifying the Kyoto Protocol and establishing a national emissions trading scheme.

...

In August [2006], Premiers and first Ministers released a discussion paper on a possible design for a national greenhouse gas emissions trading scheme. A national scheme could start as soon as 2010 if State and Territory governments agree to proceed with it. The [NSW] Government is keen to maintain the incentive to invest in low-emission generation and abatement projects until a national emissions trading scheme is established. Unless honourable members pass this bill, the New South Wales Greenhouse Gas Abatement Scheme will end in 2012, leaving business without the certainty it needs to invest now in an environmentally responsible way.

...

Without a clear signal that carbon trading will continue beyond 2012, investment in environmentally friendly technologies under the Greenhouse Gas Abatement Scheme may dry up. For this reason, the [NSW] Government decided to extend the Scheme until a national emissions trading scheme is established. The bill extends the scheme without major amendments. This is an interim measure to provide continuity for investors facing the uncertainty that the New South Wales scheme may end before a national emissions trading scheme begins. If it becomes clear that a national emissions trading scheme is not going to be established or will be delayed indefinitely, the [NSW] Government will conduct a wide-ranging review of the New South Wales Greenhouse Gas Abatement Scheme. The aim of such a review would be to ensure the extended scheme continues to meet the government policy objectives over a longer time frame than currently anticipated. These objectives include a future transition to a national emissions trading scheme.

...

The major provision in the bill is to extend the operation of the New South Wales Greenhouse Gas Abatement Scheme from 2012 to 2021 and beyond or until a national emissions trading scheme is established.

...

This bill extends the New South Wales Greenhouse Gas Abatement Scheme without major amendment, while allowing the Governor to suspend the operation of the scheme once a national emissions trading scheme is established.

As mentioned in the second reading speech, in August 2006 the states and territories released a discussion paper on the possible design for a national emissions trading scheme, which had a potential start-date of 2010. It was made clear that GGAS would be terminated if such a scheme were implemented.

The Australian Government is not in a position to verify claims by some stakeholders that the NSW Government had given direct assurances that GGAS would be extended to 2020. Given the conditional nature of the GGAS extension, the Australian Government will not provide any assistance in relation to lost NGAC revenue beyond 2012.

Transitional package

The NSW and ACT governments are responsible for transitional arrangements—they control GGAS and can affect its operation and termination. However, the Australian Government also has an interest in ensuring that adequate arrangements are made to reduce compliance costs and increase efficiency. The Government will continue to work with the NSW and ACT governments to help them develop appropriate transitional arrangements, including by contributing to a financial package for the transition of GGAS.

It is important that the form of any assistance should not increase implementation risks for the national Scheme or reduce the Government's policy flexibility. If assistance were in the form of a free allocation of permits, as requested in the NSW Government submission and by several stakeholders, it would add an unnecessary complication to Scheme design. This could be avoided if any assistance is provided outside the Scheme, such as in the form of a cash assistance package.

The Australian Government encourages the NSW and ACT governments to terminate GGAS one day before the Scheme begins. It will continue to seek agreement with the NSW and ACT governments on GGAS termination. The Government prefers that any funds be distributed by the NSW Government under agreed terms. However, should agreement not be reached on this approach, the Government will consider providing some limited assistance for the benefit of GGAS participants. Priority will be given to adversely affected cogeneration (being rewarded for avoided methane creation), landfill gas and waste coal mine methane generators directly, and, as a lesser priority, to holders of unused NGACs. The NSW and ACT Governments are encouraged to take steps in their power to reduce the number of unused NGACs in existence at the start of the Scheme.

Policy position 15.2

The Australian Government will continue to seek an agreement with the NSW and ACT governments on GGAS termination. However, should agreement not be reached on this approach, the Government will consider providing some limited assistance for the benefit of GGAS participants, with priority given to adversely affected cogeneration (being rewarded for avoided methane creation), landfill gas and waste coal mine methane generators directly, and, as a lesser priority, to holders of unused NGACs.

The Australian Government will also allow GGAS forestry projects to opt into the Scheme, provided they meet the Scheme eligibility requirements.

15.2 Credit for early action

Credit for early action would involve allocating carbon pollution permits to companies that reduce their emissions before the Scheme begins.

The Green Paper gave the establishment of an early action credit regime a low priority compared to the design of essential components of the Scheme. The Government encouraged early action and considered that businesses would be adequately rewarded for early action with the commencement of the Scheme and the incentives it would create to reduce emissions between publication of the Green Paper and Scheme commencement.

The options discussed related only to abatement between 3 June 2007 and the start of the Scheme. A further option, giving credit for action before 3 June 2007, was not considered because it would not achieve the basic objective of promoting additional abatement before the start of the Scheme and would be impossible to verify and allocate transparently and fairly.

Green Paper position

A program for allocating early action credits would not be established.

The few stakeholders who commented on this issue generally supported recognition of action that they had undertaken to reduce emissions. For example, Visy (Submission 437, p. 6) and the Chamber of Commerce and Industry of Western Australia (Submission 500, p. 12) maintained that credit should be given to businesses that took early action to reduce their emissions.

With only two years before trading commences, and early action arrangements yet to be designed or introduced, the scope for delivering additional abatement through early action crediting is limited:

- It would take some time to develop an administrative system for approving early action project proposals, even if that system were based on an existing program, such as the Greenhouse Friendly initiative.
- Experience with previous grants programs, such as GGAS, has shown that planning, development approvals, environmental approvals, financing, and construction and

commissioning of plant take several years. Therefore, it is highly unlikely that major projects with large-scale abatement benefits could be executed in time to produce emissions reductions in 2008, 2009 and part of 2010.

In addition, businesses are likely to seek to reduce emissions in preparation for the start of trading. A key advantage of a cap and trade scheme is that it implicitly rewards early action by reducing the number of permits that a business will be required to surrender to government (or the associated carbon cost passed on by another entity).

For these reasons, the Government confirms its Green Paper position that no special scheme giving credit for early action will be created.

Policy position 15.3

A program for allocating early action credits will not be established as companies that have taken action ahead of the introduction of the Scheme may already be benefiting from lower input costs and will continue to benefit under the Scheme through avoidance of higher energy costs or Scheme liabilities.

15.3 Carbon cost pass-through

The Scheme will impose a cost on carbon pollution that will change the relative prices for goods and services throughout the economy. In general, the additional cost to those producers required to surrender permits will be passed through the production chain and will be reflected in the final price for a product.

However, in some cases, economic, regulatory or contractual barriers might prevent carbon cost pass-through initially:

- Economic barriers, such as international competition, might impede the ability of domestic retailers to pass on the carbon price in international markets. This issue is particularly relevant for emissions-intensive trade-exposed industries and is dealt with in Chapter 12 of this White Paper.
- Regulatory impediments, such as retail energy market price caps, could impede retailers' ability to pass on the carbon price.
- Contractual impediments (that is, absent or ambiguous cost pass-through clauses in contracts) might also impede the ability of producers to pass on the carbon price resulting from Scheme obligations.

There are two main effects of constraints on businesses' ability to pass through carbon costs:

- it is likely to be more difficult and expensive for Australia as a whole to meet any particular emissions target if price signals that guide production, investment and consumption decisions to reduce emissions are blocked, and prices do not reflect reasonable carbon costs
- regulatory or contractual impediments to cost pass-through may increase the impact of the Scheme on particular firms or industries.

15.3.1 Regulatory impediments to carbon cost pass-through

Ideally, there should be no regulatory impediments to the pass-through of reasonable carbon costs. Various stakeholders commented on the impacts of regulatory impediments to carbon cost pass-through.

The National Electricity Law and National Gas Rules, along with individual retail price regulation regimes, will also need to ensure that any prudently incurred scheme related costs are included in pricing determinations. (Energy Supply Association of Australia and others, Submission 715, p. 12)

Network businesses would require that the cost associated with the purchase of carbon permits is able to be recovered in charges to customers. However, regulated businesses are subject to revenue/price caps, and specific pass-through provisions would be required. ... SP AusNet believes that there is a need for the White Paper to give some certainty to regulated businesses on pass-through, as part of the design of the scheme. This should provide the specific mechanisms for pass-through, or, provide sufficient direction and intent for energy sector rule makers to make the necessary pass-through provisions in rules. (SP AusNet, Submission 729, pp.1–2)

Origin Energy, commenting on regulation in energy markets, argued:

With the introduction of the [scheme] in 2010, Origin believes that a renewed priority must be placed on de-regulating retail prices in accordance with the commitments made by all energy ministers under the Australian Energy Markets Agreement (AEMA). (Submission 815, p. 108)

The Energy Supply Association of Australia noted:

Electricity and gas tariffs are optimally set by competitive markets and the Energy Industry strongly believes that retail price regulation should be removed in all competitive markets immediately. Retail price regulation in competitive markets provides no benefits but imposes considerable direct and indirect costs. Where competitive markets are not in place, and where jurisdictions retain inefficient price regulation despite competitive markets, it is vital that regulated tariffs are adjusted in a timely manner to fully allow for increased energy costs under the scheme. (Submission 715, p. 22)

Retail price regulation would prevent retailers from passing on higher wholesale energy costs in a timely manner. Retailers could therefore experience significant losses and be unable to contract forward with the remaining generators, forcing their eventual exit. (Submission 715, p. 7)

The National Electricity Law and the National Gas Law already enshrine the principle that every regulated transmission and distribution network service provider is to be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing network services and complying with regulatory obligations. Consistent with access regulation under the *Trade Practices Act 1974* (Cwlth), the application of this principle to pricing decisions will guarantee that regulated gas and electricity network charges reflect the efficient costs of complying with the Scheme and any increase in supply costs that result from it.

In 2006, the COAG Australian Energy Market Agreement was amended such that '[a]ll Parties agree to phase out the exercise of retail price regulation for electricity and natural gas where effective retail competition can be demonstrated' (clause 14.11). The process for achieving this is for the AEMC to conduct reviews of the effectiveness of competition in each relevant market and provide a report to the relevant jurisdiction on whether or not there is effective competition and ways in which retail price regulation can be phased out. Jurisdictions have six months to provide a public response to that report.

In 2007, the AEMC reviewed the Victorian market and found that there was effective competition in that market. In 2008, the AEMC has been reviewing the South Australian market and has made a finding of effective competition. While the COAG agreement indicates that reviews of each jurisdiction should ordinarily take place each two years, resourcing of the reviews has meant a more staged approach has been adopted. The agreement also sets out that retail price regulation should not hinder further development of competition (clause 14.12(a)).

In considering the interaction of the Carbon Pollution Reduction Scheme and the operation of retail markets, the broader issue of retail price regulation for electricity and gas consumers is being addressed through the work of the Ministerial Council on Energy (MCE). At its 31 July 2008 meeting, the MCE agreed to further consider issues of retail price regulation in light of the Scheme and the expanded national Renewable Energy Target and report on this to COAG. On 25 August 2008, under direction from the MCE, the Australian Energy Market Commission (AEMC) began the Review of Energy Market Frameworks in light of climate change policies. The review will focus on assessing how the Scheme and the expanded national Renewable Energy Target scheme might affect existing energy market frameworks and determine what, if any, amendments are needed to those frameworks as a result. The review will advise the MCE on adjustments that may be necessary to ensure that energy markets can continue to promote the ongoing efficiency, reliability and security of electricity and gas supplies in the long-term interest of consumers.

The Energy Supply Association of Australia, in commenting on the work of the MCE, stated:

This process is insufficient to ensure the removal of retail price regulation as there is no obligation on individual jurisdictions to remove retail price regulation even where the markets are demonstrated to be competitive. In fact, several State Energy Ministers have indicated that they will not remove retail price regulation even if their markets are shown to be competitive. Consumers can only respond to the emissions price signal to improve their energy efficiency if they are exposed to the real price increases that will flow from the scheme. The removal of retail price regulation would lead to more flexible tariffs, improved demand side management (including peak summer demand), greater energy efficiency and consequently a lowering in the cost of reducing emissions. Price regulation, with its inherent inefficiencies and cross-subsidies, distorts efficient market outcomes and prevents efficient price signals reaching customers, including the emissions price signal that will be provided by the scheme. (Submission 715, p. 22)

The Government notes the results of California's partial deregulation of its electricity market (see Box 15.1). If regulated retail prices do not allow for the pass-through of carbon costs, this could threaten the viability of energy retailers and, in turn, weaken their ability to contract with existing and new electricity generators.

Box 15.1: Energy security and retail price caps that do not reflect costs: the Californian experience

On 31 March 1998, California partially deregulated its electricity industry. Utilities were vertically disaggregated—generation was separated from retailers and privatised. No regulation applied to wholesale electricity pricing. However, the reform did not change the fixed, regulated retail prices paid by end users of electricity.

Wholesale prices were below regulated retail prices for several years, but surged in mid-2000 to reach more than six times the retail price. The regulated retail price was not changed. The inability of the utilities to pass through the increase in wholesale prices to consumers appears to have been a key contributor in sending California's two largest utilities into insolvency. The position of retailers was exacerbated because there was no new price incentive for end users to conserve electricity, as the retail price did not reflect the wholesale price.

While there were several likely causes of the Californian energy crisis, it appears that the inflexibility of retail prices to allow the pass-through of higher wholesale prices was a contributing factor.

Competition and consumer choice in retail energy markets is the best way to achieve a cost-effective demand-side response and to protect consumers from being overcharged for the costs imposed by the Scheme. The mandatory roll-out of 'smart meters' in jurisdictions where the benefits outweigh the costs will help consumers manage their energy demand and has the potential to deliver considerable carbon savings, as demonstrated by the MCE's cost-benefit analysis.

Nonetheless, even in competitive markets, vulnerable and low-income consumers' interests need to be recognised. The general market framework already provides particular protections, and the household measures package will alleviate the impacts of the Scheme. The Government has proposed a significant package of assistance to help low-income households adjust to the impact of the carbon price, which compensates them for the higher electricity prices resulting from the Scheme (see Chapter 17). Those measures will deal with equity issues directly, and in a manner that is more effective and efficient than would artificially suppressed energy prices.

The Australian Government also recognises that there are markets in which competition may not yet be effective and retail price regulation may be necessary to protect consumers from monopoly pricing. The Government notes the importance, in those markets, of independently administered price controls that reflect the underlying costs of service provision, including network pricing signals, the costs imposed by the expanded national Renewable Energy Target and the increased wholesale prices resulting from the Scheme. Failure to adequately provide for recovery of those costs would reduce the potential for competition to develop and could threaten the long-term security of supply if retailers do not have viable business models. Nonetheless, these matters should be addressed through the MCE's energy market reform agenda, rather than in the implementation of the Scheme.

The Australian Government recognises the importance of carbon cost pass-through in energy markets to ensure that Scheme objectives are not undermined. The Australian Government

supports the work of the MCE and the review currently being conducted by the AEMC and places a high priority on removing unnecessary, inefficient and distortional regulatory barriers to carbon cost pass-through. It strongly urges state and territory governments to ensure that there are no regulatory impediments to the pass-through of costs in retail electricity and gas prices.

Policy position 15.4

The Australian Government supports the work of the MCE and the review currently being conducted by the AEMC and places a high priority on removing unnecessary, inefficient and distortional regulatory barriers to carbon cost pass-through.

15.3.2 Contractual impediments to carbon cost pass-through

A number of stakeholders have claimed that the terms of their contracts with their customers do not allow them to pass on carbon costs (that is, the costs of complying with the Scheme). There are several potential reasons that contracts might not allow carbon costs to be passed through:

- the issue was considered, but not judged to be material
- the issue was considered and judged to be material, but the carbon cost price risk was consciously allocated to the seller
- the issue was considered and judged to be material but an alternative mechanism for imposing a carbon price was anticipated (for example, a carbon tax), and the pass-through mechanism is not triggered by the imposition of a carbon price in the form of the Scheme
- the issue was considered and judged to be material and a pass-through provision was included that would be triggered by the Scheme, except that other contractual impediments apply (for example, an entity with operational control has obligations under the Scheme, but might not be the seller in the contract, which might be a company in a subsidiary relationship or a separate organisation, such as one in a mine owner—mine operator relationship)
- the issue was not considered (and the contract does not include a generic ‘change of law’ or ‘change of tax’ provision that is triggered by the Scheme).

The Australian Government expects that some parties will renegotiate contracts to allow full or partial pass-through of carbon costs. For instance, in the case of a coal mine supplying an electricity generator where the coal mine cannot pass through carbon costs, it is likely to be in the best interests of both the mine and the generator that the mine continues to operate. Even if the coal mine could not pass on carbon costs and the existing owners decided to exit from operations, a new mine owner would, in any event, negotiate a contract that allowed pass-through. However, it might take some time to find a new buyer and to negotiate a supply agreement, potentially affecting the profitability of the generator.

Similarly there are strong incentives for other entities, including emissions-intensive trade-exposed, to renegotiate with suppliers that are likely to cease operations if they are unable to pass on costs. A new supplier would, in any event, negotiate a contract that allowed

some level of pass-through. However, it might take some time to find a new supplier and to negotiate a supply agreement, which could affect the profitability of the entity.

That said, for other parties, renegotiation may not be possible.

The contractual impediment that arises when the entity deemed to have operational control (and thus a liability under the Scheme) is not the seller in the contract can be resolved by allowing that entity (subject to meeting specified criteria) to transfer its Scheme obligations to the entity with financial control over the facility, or from the controlling corporation to a member of its corporate group (see Chapter 7).

Creating scope for transfer of liability would help in some cases. For the remaining contractual impediments, there is no single and readily implementable solution and while the Government is aware of some parties' contractual difficulties, it is likely that there are many more.

In addition, there is considerable uncertainty among parties about whether costs can be passed on—indeed, one seller disclosed a contract to the Government as evidence of its inability to pass on costs, while the buyer showed the same contract to the Government as evidence of the cost burden it would assume.

A number of proposals have been put forward that may involve significant risks for the Government and affected parties:

- *Implement a statutory pass-through provision.* For example, the Australian Pipeline Industry Association (Submission 584, p. 3), Asciano (Submission 416, p. 8) the Australian Coal Association (Submission 530, p. 18), Babcock and Brown Power (Submission 488, p. 16), the Energy Networks Association (Submission 762, p. 8), Wesfarmers (Submission 370, p. 2) and a number of confidential submissions supported a statutory override of contracts. A number of submissions also refer to the introduction of the GST as an example of a statutory override of contracts (see Box 15.2).

However, there is a risk that implementing a statutory override of existing contracts would involve a requirement to provide on 'just terms' compensation under s51(xxxi) of the Constitution. The Government is concerned about exposing taxpayers to these risks, particularly given the lack of certainty surrounding existing contractual arrangements. In addition, a statutory override of existing contracts would set a dangerous precedent of government intervention in commercial arrangements to which the overwhelming majority of businesses would be likely to object.

- *Implement a carbon tax instead of a cap and trade emissions trading scheme.* A number of confidential submissions supported this option as a potential solution to those contracts where an alternative mechanism for imposing a carbon price was anticipated.

This proposal would be inconsistent with government policy. In addition, it could assist only some parties and might create a new set of contractual constraints.

- *Monitor developments.* For instance Origin (Submission 815, pp. 110-111) and a number of confidential submissions note that existing contracts will allocate carbon costs appropriately and that Government intervention is not required. However, some of these

submissions also note that in the event that contractual impediments remain, the Government should provide access to compensation.

This option recognises that prudent businesses would consider and appropriately deal with risks, including the potential for a carbon constraint, and that there is little that the Government can or should do. Taking no action also provides considerable incentive to parties to renegotiate contracts. However, it would result in a loss to the seller if the contract could not be successfully renegotiated.

- *Provide limited assistance to some affected parties.* A number of public and confidential submissions suggested the Government provide compensation to affected parties. However, this could impose a large and uncertain cost on taxpayers, particularly given the lack of certainty about specific contractual terms and expiration dates. In addition, assistance would dilute the incentive to renegotiate contracts.

Box 15.2: The GST and non-reviewable contracts

When the GST was introduced on 1 July 2000, there were some pre-existing contracts that did not allow the supplier to increase the price to reflect the GST. If these contracts were subject to GST:

- the supplier would have been liable to pay GST on the supply. However, it would not be able to pass on the additional cost to the recipient
- in some cases, the recipient would have been eligible for an input tax credit for GST even though the amount being paid by it to the supplier had not increased.

To ensure that suppliers were not unduly disadvantaged and recipients did not obtain windfall gains, transitional provisions were enacted to allow supplies made under these pre-existing contracts to remain GST-free until 30 June 2005, unless there was an earlier review opportunity under the contract. A similar arrangement to exempt those entities with contracts affected by contractual impediments from the Scheme would be inconsistent with Government policy and would place an unfair burden on covered entities.

In February 2005, the GST law was amended to facilitate suppliers and recipients revising the price of their long-term non-reviewable contracts to take account of the supplies becoming taxable from 1 July 2005. If a supplier and a recipient cannot agree on a revised price, the supplier can initiate an arbitration process which will result in either:

- the supplier being reimbursed by the recipient for the GST paid by the supplier or
- the liability to pay GST shifting to the recipient.

Under the arbitration process, an independent assessor is appointed to work out an appropriate revised price for the contract. If the recipient does not agree with the arbitrated offer, the recipient will be required to pay the GST instead of the supplier. In either case, the recipient's entitlement to an input tax credit (if any) is determined on the usual basis. Accordingly, even if an arbitrated offer is not accepted and the recipient is required to pay the GST (similar to the statutory override of contracts proposed by some stakeholders), a GST-registered recipient is likely to be entitled to claim an input tax credit.

Box 15.2: The GST and non-reviewable contracts (continued)

In effect, the GST arrangements prevent a windfall gain to recipients by ensuring adequate incentives for price revision. However, there is no net gain or loss due to the ability of recipients to claim an input tax credit, where entitled.

It is important to note that the GST provisions do not involve a statutory override of contracts. The recipient has the sole discretion as to whether it will accept the arbitrated offer. If it chooses not to accept the revised contract price, it will become liable to pay GST of 10% of the existing contract price.

This type of burden-shifting arrangement does not translate well to carbon cost pass-through. It is not possible to determine with certainty whether and to what extent carbon costs can be passed through. This means that the trigger for the burden-shift would be a matter of ambiguity and contention. Moreover, shifting the liability for a supplier's greenhouse gas emissions to the recipient would have the effect of substantially varying the coverage arrangements under the Scheme. It would impose a liability on entities that are not responsible for, or able to quantify, emissions (as opposed to GST payments, which are easily calculated based on known data). The supplier would have no incentive to reduce its emissions if it is not liable to surrender permits for those emissions.

Determining who will be adversely affected ahead of certainty regarding Scheme design and legislation implementing the Scheme is difficult. Parties would require the legislation implementing the Scheme to specify whether pass-through would occur in their specific circumstances (for instance, the exact wording of the final legislation may provide the necessary trigger for contracts with ambiguous or alternative forms of carbon cost pass-through). In addition, it is too early to determine which parties will be able to successfully renegotiate their contracts. For these reasons, the Government considers it appropriate to continue to monitor the nature of contractual issues, including the scope for, and progress of, commercial renegotiations.

Policy position 15.5

Based on current information, the Government will take no action with respect to contractual impediments other than as discussed in Chapter 7 in relation to the ability of firms to transfer obligations under certain circumstances. In 2009 the Government will continue to monitor the nature of contractual issues, including the scope for, and progress of, commercial negotiations, once stakeholders have had an opportunity to assess the exposure draft of the legislation.

The legislation will not contain any provisions designed to override contracts to allow for pass-through of carbon costs.

15.4 Fixed price transition

One of the central elements of the Carbon Pollution Reduction Scheme is that it places a quantitative restriction on the level of greenhouse gas emissions. The price of permits will then be determined through trading in the carbon market.

One way in which the Government can manage price risk as the Scheme is developing would be a fixed-price start, as proposed in The Garnaut Final Report (see Box 15.3). Under a fixed-price regime, liable entities would pay a fixed price for permits at surrender date at a level determined by the Government. There would be no effective cap on emissions and no trading in current vintage permits during the transitional period. A transitional fixed-price regime would, in effect, delay the commencement of the trading scheme and impose a carbon tax in the interim.

Box 15.3: Garnaut Final Report: fixed price transition period

The Garnaut Final Report recommended a transition period to the end of 2012, during which permits would be sold at the fixed price of \$20 per tonne of CO₂-e (in 2005 prices, and rising at 4 per cent a year plus the rate of inflation).

The report advocated advanced auctions of permits for the period after 2011–12, so that trading could still occur in these instruments and to allow forward prices to develop. This would provide an early price signal for the period beyond the fixed-price regime, giving firms a way of managing future price uncertainty. No import or export of credits would be allowed during the fixed-price period.

The main advantage of a transitional fixed-price regime is that it avoids the risk of price volatility in the early years of the Scheme, as the carbon market evolves and international arrangements become clearer. International carbon prices beyond the Kyoto commitment period are uncertain, and will depend on the nature of any new international agreement. Expectations of future international carbon prices, and uncertainty over those prices, will influence Australian permit prices. A transitional fixed price removes the need for businesses to manage permit price risks in the short term. It also gives businesses more time to prepare for the introduction for the Scheme.

A fixed-price regime may also allow the Government to set a price that will not be perceived as too low or too high. For example, the Garnaut Final Report (p. 350) noted:

A period of derisively low prices would be damaging for the credibility of the scheme in its formative years...The remainder of the Kyoto period is best considered as a transition period in which the emissions trading scheme is established soundly for the larger task that will lie ahead of it after 2012. The Review considers the most appropriate approach to the transition period will be to fix the permit price in order to address both the likelihood of very low prices and fears of the opposite outcome.

On the other hand, a fixed-price transition period would have a number of important disadvantages. Australia's international climate change obligations are all framed in terms of reductions in emissions. Consistent with this, the Scheme design set out in this White Paper commits to setting a quantitative target for emissions reductions. It is not possible to control both the quantity of emissions and the price of emissions at the same time through a fixed price. A fixed price can only ever be a short-term proposition as long as the Government is committed to a quantitative target, meaning that a transitional fixed price defers a period of price uncertainty, rather than avoiding it.

A transitional fixed price period may not align with an emissions reduction path that enables Australia to most efficiently meet its medium-term emissions reduction target. While the fixed price would be based on modelling, for the period it was in place the Government would not control the actual quantity of Australia's emissions:

- If the fixed price were set above the price that would be required to prevail in the market for Australia to meet its medium-term emissions reduction target, then it would impose unnecessarily high costs on the economy during its years of operation. That is, Australia may have reduced emissions by too much in the transitional period.
- If the fixed price were set below the price that would be required to prevail in the market for Australia to meet its medium-term emissions reduction target, then there is a risk that Australia may not have reduced emissions by the efficient level in the transitional period.

A fixed price could also hamper the development of a reliable price signal which is needed to inform long-term business investment. Price variation promotes market efficiency, as it ensures that the carbon pollution permit price reflects the market's most up-to-date estimates of future emissions reduction costs. That price signal, which will capture the expected future cost of abatement, will enable businesses to make informed investment decisions. A fixed-price transition period would delay the development of a full emissions trading scheme, which in turn would curb the development of a reliable price signal and appropriate risk management instruments.

This is noted by the Australian Financial Markets Association:

The fundamental problem with Professor Garnaut's proposal is that it would remove key motivating factors for the development of price discovery and risk management capabilities. Since the price of carbon would be known in a given year and also future years, depending on the likelihood and nature of an international agreement, the incentive to develop the capability to price carbon and manage the associated risk over the near term would be removed. In effect, the key function of the market in providing price discovery would be redundant and development of a viable carbon market could be delayed for years. (Submission 1023, p. 2)

Proposals for a transitional fixed price do not take into account the difficulty in later changing to a floating price determined in the market. The Government would be likely to come under considerable pressure to extend the fixed-price period, especially if the price had inadvertently been set too low to meet national emissions targets. As well as creating a further period of uncertainty for business, this would delay the market development needed to underpin the Scheme's operation.

A fixed-price transition period would also rule out linking to international markets, which would mean that liable entities could not take advantage of low-cost abatement options in other countries during the transition period.

Finally, a fixed price would not adapt during periods of slower-than-trend economic growth. Under the Scheme lower economic growth, constraints on credit, or both, will cause the carbon price to be lower and permits to be more affordable for business than otherwise. Under a fixed-price regime, the price of permits would not change, regardless of the prevailing economic conditions.

On balance, the Government considers that the disadvantages of a fixed-price transition outweigh the advantages. The Government considers that a price cap is a better way of managing excessive prices that might arise under the Scheme (see Chapter 8). Furthermore, a number of elements in the Scheme design will help participants manage price risk, without the Government directly controlling the price. Those elements include unlimited imports of eligible international units, unlimited banking, limited short-term borrowing and advance auctions of future vintage permits.

Policy position 15.6

The Scheme will not have a fixed-price transition period.