



Investor Group on
Climate Change

Climate Change Authority
Special Review Second Draft Report: Australia's climate policy options

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1. Introduction and overview

The Investor Group on Climate Change (IGCC) represents Australian and New Zealand institutional investors with over \$1 trillion of funds under management, along with members of the investment community focused on the impacts of climate and energy issues.

IGCC members are invested across the Australian economy and are part owners of most of Australia's large companies. As managers of retirement savings and pooled investments we are concerned with the evident and increasing impacts of climate change on the global and Australian economies and the flow through impacts for future investment returns.

It is increasingly apparent that there is a global economic transition underway, focused on the reduction of the emissions intensity of economic activity in order to stabilize global warming at two degrees Celsius below pre-industrial levels at most and move towards a net zero emissions economy by the second half of the century. To protect existing investments and invest in future low carbon opportunities, investors are seeking to reduce their exposure to the risks of climate change, including through a reduction in emission-intensity of the investments they currently hold and, where practicable, through allocation of investment capital to new low carbon investment opportunities.

The policy settings which Australia establishes to support our fair share in the global task of tackling global warming will determine whether this process of decarbonisation is smooth and efficient or abrupt and disruptive.

Engagement in the public policy discussion on the most appropriate policy framework for Australia are a key way in which investors can positively support the development of an economically efficient and environmentally effective policy response for Australia. We therefore welcome the opportunity to contribute to the Climate Change Authority (CCA) Review of Australia's Climate Policy Options.

2. Key principles

IGCC supports the three key principles of *cost effectiveness*, *environmental effectiveness* and *equity* proposed by the CCA as appropriate for assessing climate change policy options. In addition, it is appropriate that *international competitiveness* should be factored into any discussion on Australia's climate change policy response.

It is in Australia's economic interests to have a strong, flexible and credible climate change policy framework. There are two key considerations which should form the basis of determining Australia's climate change policy mix:

1. The source of Australia's emissions and abatement opportunities; and
2. The size of the abatement challenge and the need to increase levels of ambition over time.

IGCC members believe that Australia has a responsibility to fairly share the burden of acting on climate change given its historic and currently high emissions per capita and the fact that it is a wealthy nation with strong economic and population growth forecast. Australia therefore has the capacity and responsibility to make a strong contribution to global emissions reduction efforts. Australia's post 2020 emissions reduction target and policy response should be consistent with the international commitments set out in the Paris Agreement, including the commitment to scale up over time.

Policy design considerations also need to acknowledge the particular areas of risk and vulnerability inherent in the industrial make-up of the Australian economy. Australia's emission profile is dominated by energy, both in terms of domestic generation and international energy export. Other sectors of the economy such as the built environment, tourism and agricultural are particularly vulnerable to the physical risks and increasing impacts of climate change itself. Australia, therefore, needs an integrated and balanced policy response which delivers a pathway for transition while managing the economic impacts.

Whichever combination of policy responses Australia chooses to implement it should be acknowledged from the outset that there will be some short term cost impacts. The intent should be that these costs are both transitional and transactional, in that they should relate principally to the initial cost of adjustment for incorporating carbon into the economy, rather than structural and long term as a result of poor policy design.

Policy design should also support opportunity pursuit. Cost effectiveness as a principle needs to take into account the requirement for policy flexibility over time so as to support the investment in innovative, clean energy and CleanTech solutions required to reduce the market costs of transition. Supporting private sector investment and growth opportunities will ultimately reduce public costs and deliver greater cost effectiveness.

Given the nature of the issue being addressed, it is also critical that Australia design a policy response which is capable of delivering environmental outcomes at scale - and with the ability to scale up over time. The recently-finalised Paris Agreement is significant in that it delivers a process and pathway for ambition which increases over time. Both the commitment to target a limit to global warming of 1.5/2.00 degrees Celsius and ultimately achieve a net zero emissions economy by the second half of the century, as well as the fixed review and ratchet provisions, mean that Australia's policy response will need to build in the ability to scale up emission reductions over time in line with the agreed international process.

Clear policy signals and frameworks deliver greater investment certainty, allowing the market to move ahead of fixed policy processes and ultimately smooth the path and reduce the cost of transition.

Finally, the need to address economic competitiveness implications should be incorporated into policy design, not seen as the basis for implementing a shallow or unambitious policy response. Failure to adequately position Australian business for the global low carbon economy of the future by being over-protective is just as likely to result in diminished economic competitiveness for Australian business as an excessively onerous policy response. This is a question of policy balance and transitional pathways which incorporate a full and frank acknowledgement of the direction and pace of decarbonisation in the future, rather than being based on the economic trajectory of the past hundred years.

3. Policy options

Policy frameworks which support the kind of structural transformation implied by the need to address climate change have historically worked best in Australia when they are founded in the principles of economic efficiency and are market based.

Market based responses allow business and the market to respond flexibly and effectively. They support greater innovation and competitiveness. They promote the efficient allocation of capital and investment and generate longer term prosperity. Policy responses which are short term, fixed and

finite, or which have involved direct intervention in the market by Government, have usually proven to be less effective in supporting longer term structural change.

I. Market policies

As investors, IGCC remains supportive of the need for a market based carbon pricing solution. This has been our historical position, and remains our preferred policy response.

The IGCC supports robust, investment-grade policies to reduce emissions. IGCC members have long supported putting a price on emissions as the most effective and efficient way to provide a long-term, transparent and certain regulatory framework to address carbon risks in investment portfolios. In 2011, IGCC welcomed the passage of the Clean Energy Future legislation and said that 'it is in the interests of investors that it remain in place to maintain a certain regulatory environment.' In 2013, IGCC opposed repeal of the legislation and supported a move to a floating market price and international linkages.

A market-based carbon pricing framework has several elements that are important features of a long term, investment grade, emissions reduction policy. Some of these include:

- a scheme cap that reflects a quantified emissions reduction objective
- broad coverage of sources of emissions across the economy
- efficient carbon cost pass-through mechanisms which support targeted transitional assistance from Government, thereby increasing the cost effectiveness of policy
- demand-creation for additional, voluntary market and abatement generation projects in other sectors of the economy
- the ability to access international permits to achieve lowest cost abatement and manage competitiveness impacts
- targeted transitional assistance arrangements for trade-exposed sectors; and
- the capacity to respond to deeper reduction targets as necessary without undue policy disruption, investment uncertainty or economic cost.

Reducing Australia's emissions is a long-term project. It requires a policy framework that is stable and that is capable of being scaled up to deliver more ambitious reductions over time.

IGCC notes that while the carbon price mechanism was in place in Australia, business had strong compliance performance levels with the scheme. Efficient price discovery was achieved and market based products and services quickly emerged to help business manage the costs through traditional financial products and services. Electricity sector emissions began to reduce, and abatement opportunities under the Carbon Farming Initiative were identified and invested in in the land use and landfill sectors.

While there is no doubt that a suite of policy responses is required to achieve the structural transformation of the economy required over time, a market based carbon pricing mechanism has the ability to pull together a range of policy interventions into a single cohesive integrated framework which can flex and adjust over time in a manner which supports investment certainty and promotes environmental efficacy in a least cost manner. Equity considerations can, and should be managed through strategic interventions which do not undermine the strength of the economic signal over time.

Accordingly, Ultimately, IGCC believes that economy-wide decarbonisation is most efficiently delivered through an economy wide policy and price signal.

The need to generate investment grade policy responses able to deliver longer term structural economic transformation across the economy is also at the heart of IGCC concerns about voluntary carbon pricing mechanisms such as abatement purchase and compliance regulation targeting specific sectors.

Fixed government purchasing abatement funds are necessarily limited by budgetary cycles of 3-5 years. While contracting periods can be longer, the allocation of funding to meet longer term abatement objectives is necessarily both capped and short term. Without a market driven demand side of the market, it is not clear how voluntary project origination policy responses can scale up to meet current 2030 targets or meet future increased levels of ambition required under the Paris Agreement.

In addition, the imposition of complementary compliance frameworks on targeted sections of the business community, through mechanisms such as the Emission Reduction Fund (ERF) Safeguard Mechanism for example, limit the ability of government to efficiently balance transitional impacts while also achieving the levels of impact required to incentivize industrial transformation. Policy responses need to be woven together into a seamless framework to achieve structural change and drive long term investment certainty and capital allocation. Without a long-term framework, investment timeframes will necessarily mirror the fixed review points on the setting of baselines (and the level at which the baseline itself is set) as investors and business adopt a 'wait and see' approach to emission reduction trajectories.

Institutional investors recognize that reducing the emissions exposures in their portfolios is a strategic investment priority in the interests of long-term returns to their beneficiaries. As a result, Australian based investors are actively seeking low carbon investment opportunities.

It is clear to IGCC members that emissions must be reduced and that nations around the world are moving to decarbonize their energy markets. This is particularly acute in economies such as Australia's where energy is the largest source of emissions. Finding suitable investment opportunities is therefore a priority.

Without a carbon price, the Renewable Energy Target (RET) is currently the primary electricity sector decarbonisation policy in Australia and is to be relied upon to provide access to low carbon energy assets in the Australian market. Without a strong renewable energy policy response the ability of local investors to access low emissions assets on behalf of their beneficiaries will be greatly constrained, increasing portfolio risks.

IGCC was opposed to recent policy interventions to adjust the RET target down mid-way through the fixed policy period, owing to concerns over what the investment implications would be for both current investors and future levels of investment certainty. IGCC members are satisfied with Government statements that the RET target is now fixed and will not be adjusted again before the 2020 period expires.

However, recent experience has shown that it is crucial that climate change policies such as the RET be embedded in mainstream energy policy. Australia needs an integrated carbon and energy policy framework which accommodates both a requirement to increase levels of clean energy investment and sustainably manage broader transformational issues across the system. Market price impacts resulting from falling demand through energy efficiency and increased household solar penetration must be managed concurrently with implications for transmission and infrastructure, for example, while increased renewables generation will need to be managed alongside the removal of ageing carbon intensive assets.

Attempting to implement separate climate change and energy policies will minimize both the cost efficiency and environmental efficacy of climate change policies, and will not deliver an efficient transition to a low carbon economy.

II. Regulation

In an economy underpinned by an efficient carbon pricing mechanism, there is a role for direct regulation to play in incentivizing decarbonisation across particular sectors of the economy, and within sectors of the economy. This primarily includes emissions standards, information and disclosure requirements, direct intervention programs to address specific barriers to change or programs which accelerate normal market conditions, for example. These should be implemented alongside carbon pricing mechanisms wherever possible.

The introduction of Emissions Performance Standards for power generation, or alternately interventionist policies which remove coal fired energy from the energy system, are often cited as effective examples of regulation which can achieve targeted emissions reductions within key contributing sectors. These include, for example, the Clean Power regulations in the United States or the targeted closures of coal fired generation in the UK. However, it should be noted that both of these measures are intended to work alongside or be implemented through some kind carbon pricing mechanism to reduce costs imposts.

Within Australia, there may be a role for an explicit government policy which accelerates the closure of particularly inefficient or carbon intensive coal fired generation, but the investment, social and broader energy market implications would need to be carefully thought through and well managed within the context of an integrated carbon and energy policy framework. In addition, the removal of existing subsidies or perverse incentives for emissions intensive activities or practices should be reviewed and considered under the umbrella of direct regulation.

IGCC also believes there is a role for climate change policy to facilitate and accelerate technological and market support for climate change solutions. Policy responses should incorporate the flexibility required to support investment in the innovation, clean energy and CleanTech solutions required to reduce the market costs of transition. Supporting private sector investment and growth opportunities will ultimately reduce public costs and deliver greater cost effectiveness.

IGCC therefore supports the continuation of finance and investment policies which support greater climate investment, including the Clean Energy Finance Corporation (CEFC) and the Australian Renewable Energy Agency (ARENA). IGCC believes that an independent financing institution is a key complementary policy measure to stimulate and accelerate the transition to a low carbon economy. The CEFC has a critical role to play in deploying public sector capital to encourage private sector investment in areas where private sector capital is needed to fund the transition to a low carbon economy.

IGCC would support the development of Vehicle Emissions Standards as a suitable form of transformative regulation for the transport sector, alongside measures which support the deployment of electric vehicles and other low emissions forms of transport. In addition, further policy to support greater emissions reduction across the refrigerants sector would be appropriate.

The built environment and the property sector is another area where there may be some opportunities for additional direct regulation to facilitate the transition of both new and existing stock to a low carbon operating environment.

4. Finding the right fit between sectors and policies

As noted above, IGCC remains supportive of the need for a market based carbon pricing solution. This has been our historical position, and remains our preferred policy response.

The IGCC supports robust, investment-grade policies to reduce emissions. We have long supported putting a price on emissions as the most effective and efficient way to provide a long-term, transparent and certain regulatory framework to address carbon risks in investment portfolios.

The need to consider the varying issues and impacts across industry sectors, support consideration of an integrated suite of policy responses to achieve the structural transformation of the economy required over time. IGCC believes that a market based carbon pricing mechanism has the ability to pull together these disparate and time-bound policy interventions into a single cohesive integrated policy framework which can flex and adjust over time in a manner which supports investment certainty and promotes environmental efficacy in a least cost manner.

Ultimately, IGCC believes that economy-wide decarbonisation is most efficiently delivered through an economy wide price signal which incorporates industry sector specific requirements within the underlying policy design.

5. Addressing international competitiveness concerns

The recently finalised Paris Agreement settled by 195 countries marks a clear shift in the international approach to global climate change policy, with significant implications for the development of Australia's climate change policy response.

Principally, it delivers a process and pathway for climate ambition which increases over time. Both the commitment to target a limit to global warming of 1.5/2.00 degrees Celsius and ultimately achieve a net zero emissions economy by the second half of the century, as well as the fixed review and ratchet provisions, mean that every country's policy response will need to build in the ability to scale up emission reductions over time in line with the agreed international process. This sends a strong market signal of transition and decarbonisation across the global economy.

Economic competitiveness in the carbon constrained global economy will be driven by smart, efficient and effective climate change policies. Government has a critical role to play in assisting Australian business to transition to a low carbon operating environment in an economically efficient way. This should also have due consideration to the structural and social implications of economic transformation.

It is also worth remembering that the climate change policies set out under the Paris Agreement to be implemented by other nations will also impact Australia's economic competitiveness. As key export markets set their own carbon and energy targets, these will flow through to energy exports in particular. In addition, the review mechanism and the commitment of parties to the Paris Agreement to avoid backsliding provide greater confidence and a review mechanism to address concerns about carbon leakage.

At an economy-wide level, the need to address economic competitiveness implications should be incorporated into policy design through short term assistance measures and long term transformative incentives. It should not be seen as the basis for implementing a shallow or unambitious policy response. For emissions-intensive, trade exposed companies, failure to adequately position Australian business for the global low carbon economy of the future by being over-protective is just as likely

to result in diminished economic competitiveness as an excessively onerous policy response.

This is a question of policy balance and transitional pathways which incorporate a full and frank acknowledgement of the direction and pace of decarbonisation in the future, rather than locking in a policy response grounded in the economic trajectory of the past hundred years. To be sustainable, carbon considerations need to be embedded in mainstream economic, infrastructure and energy policy frameworks.

6. Conclusion

Australia now has a number of years' direct experience in implementing various climate change policy options in response to the changing debate. The time is right to revisit some of the underlying assumptions which form the basis of the climate change policy debate in light of recent experience and particularly following the finalization of the historic Paris Agreement.

In summary, Australia needs to pursue an integrated climate change policy response which facilitates an economically efficient transition to a low carbon economy, while playing our fair share in the global task of avoiding dangerous global warming. Market based mechanisms have historically proven most effective at delivering policy objectives, coupled with direct regulatory interventions where necessary and as appropriate.