Australian National University

Submission to Safeguard Mechanism reform consultation

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ANU Institute for Climate, Energy and Disaster Solutions

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1. Summary of recommendations

The Safeguard Mechanism (SM) is designed as the centrepiece of Australian federal climate change policy during this term of parliament. It could in time become the core of a cost-effective climate policy that covers other sectors.

> Recommendation 1: The SM needs to be designed and implemented for maximum effectiveness and economic efficiency to allow a large contribution to achieving Australia's national emissions target cost-effectively.

The aggregate baseline under the Safeguard Mechanism needs to be sufficiently low to create appropriate incentives in the industry sector and provide a commensurate contribution to the national emissions outcome, taking into account the relative opportunities and likely climate policy coverage in other sectors of Australia's economy. Decline rates for baselines should be such that aggregate emissions covered by the SM should be more rapid than the economy wide rate required to achieve the 43% target. There is a need for quantitative analysis to inform decisions about baselines, and for these decisions to be made in the context of Australia's overall emissions reductions options.

> Recommendation 2: Aggregate rates of decline for baselines should be more rapid than the economy wide rate required to achieve the national 43% target, and be informed by quantitative analysis of possible emissions reductions trajectories across the economy.

The reform of the Safeguard offers the opportunity for a reset of baselines, to base them on consistently applied principles. This opportunity should be taken in the interest of effectiveness, transparency and fairness.

> Recommendation 3.1: Future baselines should be intensity based, recognizing the present design of the SM and likely expectations and preferences by participants. The resulting absence of incentive to cut or curtail Australian production in order to meet the baseline obviates the need for special treatment of EITEs, and no special treatment should be provided.
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> Recommendation 3.2: Headroom in baselines should be removed by resetting all baselines, basing them on consistently applied principles.
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> Recommendation 3.3: All baselines should be industry-based benchmarks. There should be no facility-based benchmarks.

The provision of offset credits into the SM would carry significant difficulty and risk.

> Recommendation 4.1: Safeguard Mechanism Credits (SMCs) be issued automatically to facilities with emissions below their baseline, and temporal flexibility should be allowed through banking and borrowing with appropriate limits on borrowing.
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> Recommendation 4.2a: There needs to be qualitative restrictions on Australian Carbon Credit Units (ACCUs) allowed under the SM, in order to exclude low integrity credits.
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> Recommendation 4.2b: Safeguard facilities should no longer be able to generate ACCUs for reducing direct (scope 1) emissions unless they have an

existing registered Emissions Reduction Fund (ERF) project; and these should be subject to double counting prevention. No new ERF projects should be able to be registered at Safeguard facilities.

Recommendation 4.3: International offsets should not be included in the SM, and no provision should be made at this time for their possible future inclusion.

Providing special treatment for emissions-intensive trade-exposed industries (EITEs) would negatively affect the SM's effectiveness and create problematic threshold effects. Provision of financial or crediting assistance invariably is arbitrary and comes at a cost to other SM participants or the broader community, and both create incentives for lobbying. Special treatment for EITEs also raises the risk of carbon border adjustments being applied to exports from Australia. Under emissions intensity baselines there is no significant incentive to cut or curtail Australian production in order to meet the baseline. This obviates the need for special treatment of EITEs, and no special treatment should be provided.

Recommendation 5: EITEs should not receive special treatment or special support.

Multi-year monitoring should in general not be necessary.

Recommendation 6: Multi-year monitoring periods should be tightly restricted.

On baseline decline rates, the following recommendations are made, including with reference to recommendations above.

Recommendation 7: Baselines need to reduce at a sufficiently rapid rate to provide incentives for industry sector to contribute commensurately to the national emissions reduction effort. Emissions intensity reduction rates should as a default be uniform across industries, and uniform across multi-year periods (e.g. over 5-year blocks). There is no case for starting with lower baseline reduction rates. Setting aside a 'reserve' can be considered, however rules around such a reserve will need to be tightly defined.

On other issues, the landfill sector is not well suited for inclusion in the SM.

Recommendation 8: The landfill sector should not be covered by the SM.

2. Contribution to the national emissions reductions task

Australia's industry sector is second only to electricity generation in the scope to reduce emissions over the medium term. It is of paramount importance to put in place a mechanism that provides a consistent and sufficiently strong economic incentive across the industry sector to achieve emissions reductions at a scale that is in line with the sector's contribution to a cost-effective emissions reductions effort across the economy.

To achieve this, the aggregate baseline for covered installations will need to be sufficiently low by 2030. Annual reductions need to be sufficiently large from the start in order for the industry sector to make an appropriate contribution to achieving Australia's carbon budget over the decade.

If the aggregate industry baseline were not sufficiently low then other parts of Australia's economy will need to reduce emissions by a disproportionately large extent, leading to economic inefficiency if marginal abatement costs deviate significantly. When policy parameters are set for just one part of the economy, as is the case in this process, then there can be a tendency to focus on the perceived difficulty of achieving outcomes, including as a result of industry lobbying. This can then tend to result in a bias towards inefficiently weak policy settings (high baselines).

The share that any particular sector would play in an economy-wide cost-effective abatement effort will invariably differ from its share in emissions. The industry sector overall will likely have less opportunity to reduce emissions at a given marginal cost than the electricity generation sector, however no comparable policy framework to incentivize more rapid emissions reductions in electricity generation is planned; and many parts of the industry sector have inherently greater opportunity to cut emissions than parts of the transport, agriculture and building sector. If non-industry emitters are not covered by effective policy measures to reduce emissions, as is the case now and under present government policy settings and plans, then the reductions in emissions from the industry sector need to be proportionally larger still.

On the balance of considerations, for the industry sector to contribute effectively to the national emissions reductions outcome, decline rates for baselines in aggregate should be more rapid than the economy wide rate required to achieve the 43% target.

In relation to the proportional share of future emissions, the Consultation Paper states that "The Safeguard Mechanism can be considered to cover 'hard to abate' sectors, where some emissions sources, such as process-related emissions, face challenges in terms of abatement technologies and costs"; no contrasting statement is made about opportunities for large and low-cost emissions reductions options in industry which also exist. This in itself suggests a tendency towards openness to high baselines, apparently without analytical underpinning.

This analytical underpinning needs to be created, as a firm basis for decisions about the overall rate of baseline declines and hence the overall ambition inherent in a reformed SM. This analysis should be done separately (a) under a cost-effective comprehensive national climate policy framework, and (b) under a policy framework

that provides only partial incentives or regulatory/fiscal action to reduce emissions as is currently the case and planned. The aggregate baseline under the SM should be set accordingly.

> Recommendation 2: Aggregate rates of decline for baselines should be more rapid than the economy wide rate required to achieve the national 43% target, and be informed by thorough quantitative analysis of possible emissions reductions trajectories.

3. Baselines

3.1 Fixed vs intensity baselines

As explained in the Consultation Paper, intensity baselines are attractive to emitters who expect an increase in output over time, because a rise in output by particular installations or industries are not directly penalized. Rather such specific increases (which lead to specific increases in emissions) need to compensated for across the mechanism. The SM is currently almost fully under intensity baselines (though these are set so high as to be ineffective).

Under intensity baselines, there is not a strong argument for special treatment for EITEs, because there is no incentive to cut Australian production in order to meet or exceed the baseline.

> Recommendation 3.1: Future baselines should be intensity based, recognizing the present design of the SM and likely expectations and preferences by participants.

3.2 Headroom in baselines

Current baselines include different amounts of headroom (where baselines are higher than actual emissions, at the facility level and on average).

There is overall no sound basis for the extent of headroom provided under existing baselines, nor the relativities between different products. It would be counterproductive to perpetuate the pattern by starting from existing headroom. Furthermore (as explained in the Consultation Paper) this would spell the need for relatively high annual reduction rates in baselines, and it would make for a relatively slow start to the effectiveness of the SM, running counter to the objective of meeting a national emissions target.

The reform of the SM offers the opportunity for a reset of baselines, to base them on consistently applied principles. This opportunity should be taken in the interest of effectiveness, transparency and fairness.

> Recommendation 3.2: Headroom in baselines should be removed by resetting all baselines, basing them on consistently applied principles.

3.3 Baselines for existing facilities

The SM to date employs a mix of industry-average benchmarks and site-specific benchmarks. The latter tend to perpetuate rights to emit at high intensities and are a key contributor to headroom.

A system where all facilities are covered by industry-average benchmarks, and none by site-specific benchmarks, is logical and a key underpinning of a system that provides full incentives to reduce emissions across the industry sector. It is also essential for transparency and arguably for procedural fairness, and to avoid distortions arising from lobbying by special interests.

The reform of the SM offers the opportunity to convert all baselines to industry averages. This opportunity should be taken in the interest of effectiveness, transparency and fairness.

> Recommendation 3.3: All baselines should be industry-average benchmarks.

3.4 Baselines for new facilities

The choice suggested in the Consultation Paper is for new entrants to either get industry-average benchmarks or best-practice benchmarks, which would translate to lower baselines.

Applying best-practice benchmarks only to new entrants would put new entrants at a competitive disadvantage to existing facilities, and thereby would tend to slow the process of replacement of old facilities with new ones. They amount to an implicit subsidy to incumbents.

Applying industry average benchmarks to new entrants does not compromise incentives by new entrants to deploy best available technology, if there is crediting for remaining below the baseline.

> Recommendation 3.4: New entrants should receive industry-average benchmarks.

4 Crediting and trading, domestic offsets and international units

4.1 Crediting and trading

The Consultation Paper proposes that SMCs be issued automatically to facilities with emissions below their baseline. This ensures that all facilities covered by the SM will face the same incentive (price signal) to reduce emissions. There are no specific other issues to consider, if baselines are set consistently based on principles as per section 3.

The Consultation Paper describes options for temporal flexibility through banking and borrowing. This is a desirable feature if appropriate limits on borrowing are implemented, as suggested.

> Recommendation 4.1: SMCs be issued automatically to facilities with emissions below their baseline, and temporal flexibility should be allowed through banking and borrowing with appropriate limits on borrowing.

4.2 Offsets

With ACCU offset credits allowed into the SM, the integrity of the SM and thereby the achievement of Australia's national emissions target overall in part will depend on the quality of ACCUs. There needs to be qualitative restrictions on ACCUs allowed under the SM, in order to exclude low integrity credits. This can be tied to the results of the Chubb Review, plus subsequent integrity actions taken by ERAC or another responsible agency.

> Recommendation 4.2a: There needs to be qualitative restrictions on ACCUs allowed under the SM, in order to exclude low integrity credits.

The Consultation paper discusses provisions for ERF projects producing ACCUs at Safeguard facilities. The logic of a functioning SM demands for there to be no such projects at SM facilities; exceptions could be made for existing projects.

> Recommendation 4.2b: As suggested, Safeguard facilities should no longer be able to generate ACCUs for reducing direct (scope 1) emissions unless they have an existing registered ERF project; and these should be subject to double counting prevention. No new ERF projects should be able to be registered at Safeguard facilities.

4.3 International offsets

The Consultation paper appropriately discusses the difficulties, uncertainties and risks that would come from the use of international offsets in the SM.

At this stage, international offsets remain ill defined. The likelihood is that integrity and quality of international offsets will continue to be difficult to assess. Some types of offsets could be available in markets at very low prices, thereby reducing the incentive to reduce emissions within any scheme that allows them for compliance purposes.

For the foreseeable future, the key useful role of international offsets is for governments to purchase them, or invest in their creation in government-to-government programs, for the purpose of helping achieve an overall national target while financially supporting emissions reductions action in developing countries. This does not require inclusion of international offsets in the SM.

If this situation were to change in future, the SM could be amended then.

> Recommendation 4.3: International offsets should not be included in the SM, and no provision should be made at this time for their possible future inclusion.

5. Emissions-intensive, trade-exposed industries

The Consultation Paper provides an extensive discussion of emissions-intensive, trade-exposed industries. It suggests the possible provision of financial assistance to EITEs, or direct provision of SMCs.

There is no case for special treatment of, or assistance to, EITEs under a system of intensity baselines (as explained under 3.1).

EITEs comprise a substantial share of facilities covered by the SM. Providing special treatment for these would negatively affect the SM's effectiveness. Defining EITEs invariably creates problematic threshold effects, provision of financial or crediting assistance invariably is arbitrary and comes at a cost to other SM participants or the broader community; and both create incentives for lobbying at the expense of other scheme participants and the broader community. Special treatment for EITEs also raises the risk of carbon border adjustments being applied to exports from Australia.

Treating EITEs like any other facility under the SM substantially reduces the likelihood of such penalties being applied. Under emissions intensity baselines there is no significant incentive to cut or curtail Australian production in order to meet the baseline. This obviates the need for special treatment of EITEs, and no special treatment should be provided.

> Recommendation 5: EITEs should not receive special treatment or special support.

6. Multi-year monitoring periods

Multi-year monitoring should in general not be necessary.

> Recommendation 6: Multi-year monitoring periods should be tightly restricted.

7. Baseline decline rates

The rate of decline in baselines is the single most important parameter for the SM, as it will determine the overall effectiveness of the mechanism, including through the level of the price signal created.

Baselines need to reduce at a sufficiently rapid rate to provide incentives for industry sector to contribute commensurately to the national emissions reduction effort, as discussed under 2.

In response to the aspects mentioned in the Consultation Paper:

Framework:

Assuming an emissions intensity based framework, the reduction in emissions intensity needs to accord with the desired target in absolute terms (e.g. for 2030), together with expected rates of growth or decline in industrial activity over time. Emissions intensity

reduction rates should as a default be uniform across industries, and uniform across multi-year periods (e.g. over 5-year blocks).

Reserve:

Setting aside a 'reserve', e.g. in the form of SMCs that could be issued into the market or easing of baseline reduction rates, can be considered. However, rules around such a reserve will need to be tightly defined, as releasing the reserve would increase the emissions reductions task in the other parts of the economy. The trigger for a release of a reserve should be price-based, making the reserve an effective price ceiling in the market for SMCs, or a price dampening mechanism. Design elements of the EU emissions trading scheme Market Stability Reserve could be considered.

Linear decline or soft start:

There is no strong case for starting with lower annual baseline reduction rates which imply higher reduction rates down the track. Starting at or near present average emissions intensity levels, rather than below present averages (best practice), would already constitute a form of soft start.

Treatment of EITEs:

No special baseline provisions for EITEs are recommended. Under emissions intensity baselines there is no significant incentive to cut or curtail Australian production in order to meet the baseline. This obviates the need for special treatment of EITEs, and no special treatment should be provided.

8 Other issues

The landfill sector is ill-suited to be included in the SM. Factors include site specific factors that drive capture efficiencies, relative lack of competition between sites which means no effective prospect for substitution based on emissions intensity differences, and the separation between landfill owners and landfill gas operators.

Recommendation 8: The landfill sector should not be covered by the SM.

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Department of Climate Change, Energy, the Environment and Water
Safeguard Mechanism Taskforce

Re: Submission to Safeguard Mechanism Consultation

Please find enclosed a submission to the Safeguard Mechanism Consultation by the ANU Institute for Climate, Energy and Disaster Solutions (ICEDS).

ICEDS connects industry, governments and broad communities with climate, energy & disaster-risk research from the Australian National University. Our goal is to advance innovative solutions to address climate change, energy system transitions and disasters. We facilitate integrated approaches to research, teaching and policy engagement across disciplines.

The following Institute members have contributed to this submission: Prof Frank Jotzo, A/Prof Emma Aisbett, Prof Andrew Macintosh.

We will be happy to elaborate on the points made in the submission and on other relevant analysis. A wider group of ANU researchers will be able to provide relevant analysis and insights.

Sincerely,

Prof Frank Jotzo
Head of Energy,
ANU Institute for Climate, Energy & Disaster Solutions