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EMISSIONS TRADING SCHEME DISCUSSION PAPER

Origin Energy (Origin) welcomes the opportunity to respond to the Garnaut Review’s (the Review) Emissions Trading Scheme (ETS) Discussion Paper. Origin is committed to contributing to the discussion in an informed and meaningful way.

Origin’s thinking with respect to the ETS is underpinned by the fundamental view that a nationally coordinated, sustainable and competitive energy market is the most effective model to deliver efficient investment and competitive pricing in the energy sector. It is also core to dealing with the challenges imposed by climate change.

Origin believes an ETS will act to provide a clear carbon price signal for the energy sector, which will then respond through optimising the fuel mix and long term investment to deliver least cost emission reductions within the scope of targets set. Origin believes with the right design the industry will deliver the significant emission reductions required.

Summary of Key Points

Summarising the views discussed in this paper, Origin supports:

- Strong domestic abatement targets informed by scientific research and international abatement activity.
- An ETS as the central mechanism for achieving Australia’s abatement targets with complementary measures that facilitate the structural changes needed to achieve Australia’s abatement targets.
- A stable, clearly defined market that supports long term investment decisions by:
  - Striking the right balance between domestic action and international linkage, including access to the Clean Development Mechanism.
  - Imposing penalties that will ensure the environmental integrity of the ETS.
  - Providing market flexibility in the form of banking and limited borrowing.
  - Ensuring the competitive pass through of carbon costs to the end user.
- A high a level of permit auctioning to facilitate the development of short term market liquidity.
- A MRET scheme to provide an interim long term price signal to support the accelerated development of low emission technology.
• Funding for transmission infrastructure where market failure is identified.
• Funding for RD&D investment that encourages a broad range of low emission technologies as possible.
• Assistance for affected consumer groups via the recycling of auction revenues through economically efficient mechanisms.
• Compensation on the basis of economic efficiency and equity considerations.

Origin strongly believes that investor certainty will be key to the scheme’s success in delivering emission reductions. A fundamental principle, therefore, is to design the scheme carefully upfront and leave it to operate without threat of structural change. For this reason, where flexibility mechanisms are required, they need to be built into the scheme upfront and clearly defined in terms of who can change key parameters, what can be changed, and the criteria and methodology employed to make such changes.

All things considered, the issues raised below are the most pressing for Origin at this stage.

Trajectories

Origin supports urgent action around the mitigation of greenhouse gas emissions and advocates for domestic targets that correspond to the greenhouse gas reduction targets advised by the latest scientific research set in the context of international agreements.

Determining the emissions cap or budget for the Australian Emissions Trading scheme (ETS) is a fundamental design principle and one that can be approached in any number of ways. One of the most challenging aspects of its design is to find appropriate means of achieving sufficient long term investment signals for market participants to support investment.

The National Emissions Trading Taskforce (NETT) proposal with its ten year ‘fixed’ target and gateways for future flexibility provided an appropriate term for investment certainty while allowing flexibility within the gateways thereafter. The gateway mechanism allowed the Government to move within boundaries both above and below the previous trajectory.

The Review has suggested another approach which establishes a long term set of decreasing abatement trajectories which the economy will move down, based on a set of well defined conditions principally relating to the level of international commitment on abatement activity.

Origin sees merit in this new approach in providing a level of market certainty whilst affording the Government flexibility to respond to changes in the level of international commitment established through the current round of negotiations. To instil market confidence, the approach will require significant long term commitment from successive Federal Governments and transparency around the conditions under which the Government will accelerate the move towards a low carbon economy. Clear terms of reference may be one mechanism for providing transparency whilst maintaining the flexibility needed to adjust to movements in international negotiations and scientific opinion.
Of particular importance will be the balance between domestic action and international linkage under the different trajectories. Providing domestic certainty will be critical to encouraging long life investment decisions within an ETS framework. This certainty may potentially erode if the volume of the international abatement is allowed to cannibalise the domestic contribution when moving to a tighter trajectory.

Origin recognises that the international climate change debate and activity is moving quickly. Two key dates in terms of Australia's abatement trajectory are the 2020 interim target, which the Government will release later this year, and the post Kyoto commitment, which is yet to be determined. The result of these negotiations will not only influence our abatement trajectory but the timeframes for 'set' targets/budgets.

The Review is proposing a five year set budget\(^1\) to 2015, rolled forward every year within a four stage trajectory framework. At this stage, it is not clear how the budgets and trajectory framework would tie into the Government 2020 target and Australia's post Kyoto commitments. At a minimum, the term for the first set budget should be compatible with the interim 2020 target. Trajectories should also reflect those abatement commitments.

Origin looks forward to further discussion about budgets and trajectories in the Review's June paper.

**Budgets, Banking and Borrowing**

Origin welcomes the Review's focus on an emissions 'budget', rather than annual targets, along with the concept of permit banking as mechanisms designed to enhance ETS participant flexibility over how and when to implement their own abatement initiatives.

Origin does not support unrestricted borrowing primarily due to the environmental integrity risks associated with it. However, there are significant uncertainties in the initial stages of any new market, and the greater the flexibility for participants to deal with those uncertainties, the more likely the credibility of the ETS and the long term market certainty will be maintained. On that basis, Origin would support limited banking for a two to three year period to allow participants some flexibility while fine tuning emission forecasts and determining their abatement opportunities.

**Penalties**

On the basis of environmental security, Origin supports the penalty rising to well above the marginal cost of abatement with the addition of a make good provision.

**Phasing of the ETS**

If the Review's proposals for scheme design is introduced, Australia will be the first country to adopt such measures from the outset of its scheme. For example, maximising the auction of permits, strict penalties with make good provisions and broad coverage from day one are stronger than any existing or proposed domestic scheme to date.

In contrast, the European Union Emissions Trading Scheme (EU ETS) grandfathered permits and applied an implementation Phase 1 over 2005 to 2007. This phase was intended as a 'learning by doing' period, which has provided valuable insights into the

\(^1\) The Emissions Trading Scheme Discussion Paper, p25.
operation of the EU ETS around participant’s capabilities and scheme design elements. Phase 1 afforded the modification to the design elements, market operation and leniency for participants who had unsatisfactory emissions data to support trading and compliance making for a stronger Phase 2.

The New Zealand Emissions Trading Scheme (NZ ETS) has opted for another form of flexibility by allowing a phased introduction of covered sectors and an initial waiving of the penalty rates for new emitters.

Origin is supportive of a strong framework for an ETS linked closely to the scientific targets, however the combination of a progressive framework as proposed by the Review and short timeframes for implementation provide little leeway for adjustments and for businesses to develop capacity. On this basis, Origin fully supports the provision of flexibility to ETS participants in the form of banking, limited borrowing and providing for international linkages. The question arises as to whether further flexibility is needed within an initial start up phase of the ETS to provide market confidence for long term investment.

Permit Allocation

Origin recognises that permit allocation is a complex issue. Origin agrees with the Review’s position that compensation claims should be viewed in total and that distributions should be made on the basis of economic efficiency and equity considerations. There are many valid claims for compensation across the economy, including electricity generators, trade exposed energy intensive industries (TEEs), impacted communities and individuals facing higher energy bills.

Origin also sees merit in the Review’s position that permit allocation is only one method of distributing compensation claims. There is a range of arguments in favour of auctioning compared with initial free allocation. These include simplicity in administration, avoiding problems of perverse incentives, increased liquidity in the permit market, reducing the opportunity for large participants to wield any market power and efficiency gains when combined with revenue recycling.

Origin supports assistance for existing and new TEEs to reduce the risk of carbon leakage and to minimise the impact on the Australian economy by maintaining the TEEs price competitiveness internationally. Alternative distribution mechanisms for assistance other than permit allocations should be considered.

International Linkage

Origin strongly supports Australia leading and enabling an effective global agreement to halt the impact from dangerous levels of greenhouse gas emissions. Linking the ETS internationally is key part to global leadership and the first step in this process is allowing liable parties to access the Clean Development Mechanism (CDM).

CDM will also provide an important source of liquidity and flexibility in the initial stages of the market while regional initiatives or broader links are negotiated. Furthermore, the location of the CDM projects eligible for the ETS should not be limited.

Origin is of the view that the level of international linkage needs to be balanced with the level of domestic abatement action embodied within the trajectory framework. Limitations on the volume of CERs should be set, until such time that the Australian and international markets have fully matured.
In relation to linkage with New Zealand and other domestic schemes, these should be considered on their individual merits, particularly in relation to the demand and supply issues within their own domestic regime as well as the linkages each scheme has to other schemes.

Origin sees merit in the Review’s suggestion of a potential regional abatement initiative to foster market development, however this should not limit access to the broader CDM market. The risk to the Australian economy in the initial stages should be controlled with restrictions over the volume of trade, thus allowing participation and learning without significant risk exposure or dilution of Australia’s domestic abatement effort.

Auction Revenue Hypothecation

Origin supports the hypothecation of revenue as outlined by NETT and the Review. In particular, Origin sees funding for public infrastructure as likely to be important for the efficient development of new low emission generation technology.

Under any scenario in which the electricity sector will be required to deliver significant emission reductions, Origin expects there will be the requirement for significant investment in transmission infrastructure. Origin is concerned that the current regulatory framework around transmission investment will not effectively deliver this.

Origin strongly supports funding for RD&D investment. The aim should be to provide support for a broad base of low emission technologies, thus avoiding market distortions and the potential to ‘pick winners’ by developing a large amount of only a small number of technologies.

Complementary Measures

At a minimum, Origin believes that harmonisation is needed among the various State based schemes that continue to be developed. These schemes address many and varied emission reduction activities, some of which are likely to overlap with the ETS on its introduction. Origin recognises that there are likely to be market failures that will impede the full effectiveness of the ETS, particularly around energy efficiency in the home and the take up of new technology. However, these market failures can be managed far more effectively and efficiently with coordination among Federal and State Governments. A co-ordinated effort for complementary schemes is essential before the beginning of the ETS to minimise uncertainty, given that uncertainty is already likely to be a key feature of the early stages of the ETS.

Origin believes that the major areas of residual market failure following the introduction of an ETS will be related to the time required for the market to mature to provide long term price signals, the development of low emission technology (LET), and the uptake of energy efficiency.

The EU ETS case study shows that price discovery is still in its early stages. Forward prices do not yet reflect the interest rate, as should theoretically be the case given the market design. Origin believes that the Australian ETS may be subject to the same measure of uncertainty, and therefore a robust long term price signal for Australian domestic abatement may not emerge immediately. This is reinforced by the fact that significant abatement is not likely to commence immediately as participants establish their own costs of abatement and portfolio of abatement opportunities.
Although it may take some time before the appropriate long term price signal is established in the market, Origin’s analysis indicates that investment in LET, including renewables, will be required early to achieve the expected cuts in domestic emissions required over the long term. Continued support for the development of the LET industry through the MRET scheme is therefore warranted until there is more confidence in the long term price signal by the ETS. This support should be as broad based as possible to encourage a range of low emission technologies. Origin would expect the MRET scheme to naturally phase out as the price of carbon rises to its long term level and LET investment no longer requires additional support.

Successful implementation of significant renewable and low emission generation assets is directly related to the investment in transmission networks. Without early and significant investment in this area, the optimal development of new generation will be hindered. As discussed above, Origin supports the Review’s proposal for some auction revenue being allocated to this important area of development.

Origin believes a national energy efficiency strategy that fits within the context of an ETS needs consideration. The strategy would consolidate existing measure where appropriate, be developed at the national level and in a way that considers the broader regulatory context.

Carbon Cost Pass Through

It is a widely accepted principle that the cost of carbon must be passed through to the end consumer to change behaviour and therefore maximise the efficiency and effectiveness of an ETS.

In Australia, ensuring that costs are effectively passed through is primarily dependent on how the retail regulation is structured to accommodate the price increase to the end user within a carbon constrained economy.

Fundamentally, the cost pass is more effective in a price deregulated environment where the market participants determine how and when costs should be passed through on a competitive basis. At this stage, it remains uncertain whether the State and Territory regulators will allow energy tariff increases to accommodate full pass through to the end user, thus impeding on the effectiveness of the ETS.

Origin appreciates the cost impact the ETS and other complimentary measures will have on low income households. Origin supports the Review’s proposal for assistance to groups affected by the increase in costs arising from the pricing of carbon, however distribution should occur in a way that minimises distortion in the economy. Vulnerable customers facing difficulties may be supported through energy efficiency schemes and the enhancement of hardship policies that governments and retailers already have in place. The Government could recycle permit auction revenues to support this.

International Carbon Bank

Origin seeks greater clarity around the role of the International Carbon Bank (ICB) since it has not been clearly outlined in the paper. While Origin recognises the requirement for a market regulator, it would oppose any participation in the market by the ICB beyond that role.

Tax Considerations
Given the consumable nature of the permits, acquiring, acquitting or selling of permits should be dealt with in the income tax context as any loss or outgoing being deductible in full at the time the payment is made. Where permits are retained across income tax years, the permits should be treated for income tax purposes as trading stock of any entity. For ease of administration, Origin recommends that the date of acquittal of permits be aligned to an entity’s year end for tax reporting purposes.

For GST purposes, Origin submits that the auction and sale of permits should be GST inclusive. In essence, an entity registered for GST would claim a GST input credit for the acquisition of the permit and the vendor would pay GST. This treatment has a more appropriate alignment with the GST treatment of the majority of transactions undertaken by entities that will most likely be subject to the scheme. Acquittal of the permit would not be a supply and therefore would not be subject to GST.

Origin also submits that stamp duties should not apply to the trading of permits. The matter needs to be raised with the State and Territory governments. The extra impost cost of such a duty should not be added to the extra cost that will already arise for businesses subject to the scheme.

Conclusion

Origin broadly supports the direction of the Garnaut Review and looks forward to further engagement in the lead up to, and following, the June report.

If you have any questions or would like to discuss our submission please call me on 02 8345 5301 or Simone O’Sullivan on 02 8345 5101.

Yours sincerely

[Signature]

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