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THE **GRIFFIN** GROUP

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Garnaut Climate Change Review
Level 2, 1 Treasury Place
Melbourne VIC 3002

Email: contactus@garnautreview.org.au

Dear Professor Garnaut,

The Griffin Group welcomes the opportunity to make a submission on the Garnaut Review's 'Emissions Trading Scheme Discussion'.

BACKGROUND TO THE GRIFFIN GROUP

The Griffin Group (Griffin) is a privately owned Australian group of companies which has been operating, predominantly in Western Australia, for over 80 years. Griffin owns significant operations in the areas of coal mining, electricity supply, agriculture and property.

Griffin Coal is a world class open cut mining operation producing three million tonnes of coal per year. Around half of this is supplied to the state electricity utility and the remainder to industrial customers in the alumina, cement and mineral sands industries. Griffin Coal's total minable coal reserves exceed 200 million tonnes from a total open cut resource of 400 million tonnes.

Griffin Energy was established with a view to providing a secure and reliable source of electricity into the Western Australian market. This was a direct response to the recent reforms in the WA electricity generation and supply markets aimed at encouraging private generation investment. Griffin Energy is developing a balanced portfolio of generation assets within the isolated WA market. Production of electricity is due to commence in late 2008 from the 2 x 200MW Bluewaters coal fired power station in Collie; and in joint venture with the Stanwell Corporation, Griffin operates an 80MW wind farm near Cervantes. Other generation developments include a gas fired power station north of Perth as well as further renewable energy developments including a second wind farm and innovative new wave power technologies.

GENERAL COMMENTS

Griffin supports the introduction of an Australian Emissions Trading Scheme (ETS) as part of an international effort to price the externalities brought about through the emission of greenhouse gases (GHG). Such a scheme should be broad based where practicable; offer a high level of certainty to investors; and strike an appropriate balance between the benefit of Australia's likely contribution to the global emissions reduction effort and the potential disruption to Australia's relatively emissions intensive economy.

SPECIFIC COMMENTS

The Garnaut Review's 'Emissions Trading Scheme Discussion Paper' (the Review) covers a wide range of complex issues, highlighting the enormous policy challenges around the efficient design of an ETS. Griffin expects the Review to attract a significant response from a large number of proponents, many of whom will be more qualified to respond to specific aspects of the Review. It is Griffin's intent to respond broadly to each area of policy identified in the 'Summary of Australian ETS model for discussion' with more specific comments on targeted issues of importance to our operations.

Setting an Emissions Limit

Griffin has previously espoused the adoption of a forward target trajectory for emissions, comprising a firm emissions limit for a period (nominally 10 years) and a further period of banded emissions limits (another 10 years). It is important that the forward trajectory is continuously updated (likely on an annual basis) so that there is always a 10 year firm plus 10 year banded limit horizon providing certainty for which long-lived investments may be made.

As for the limits themselves, Griffin acknowledges that international circumstances may influence Australia's adoption of emissions targets (as witnessed at the UN Climate Change Conference in Bali), however we stress that these must be balanced with economic considerations based on an emissions intensive (yet relatively efficient) Australian resources economy. Large early reductions in Australian emissions will equate to a very small contribution in the reduction of global emissions yet it may lead to substantial contraction in the Australian economy. Griffin believes that the target of global emissions reduction is best served by retaining Australia's comparative efficiency in the resources sector rather than driving resources investment offshore to less efficient jurisdictions.

Changes to the Emissions Limit

Griffin opposes movement between emission trajectories. As discussed above, long-lived investments require certainty around emission obligations. An Australian ETS should not prioritise commitments to evolving international regimes, rather it should focus on the best policy balance encouraging sustainable emissions reduction and economic growth. Governments should reconcile future credits and debits from Australia's international emissions obligations using methodologies that have low impacts on emission target trajectories underpinning and Australian ETS.

Coverage

Griffin agrees with the coverage and definition of GHG as defined under the Kyoto Protocol. As for sectoral coverage, generally the broader the coverage the better. However, it should be acknowledged that the complexity around an ETS may not provide the most effective method for reducing GHG emissions in all sectors. Where there is an inherent difficulty in measuring and baselining GHG emissions, other policy levers may be employed, such as mandating emission reduction through legislation, through targeted taxes and charges, or by rewarding verifiable GHG abatement through other means – including through the creation of offsets tradeable in an ETS.

Domestic Offsets

Griffin agrees that domestic offsets should be accepted without limits and that they will only ever make up a small part in the emission permit market. Offsets need to be properly accounted and verified to ensure the integrity of the emission permit system. It is important that rules relating to offsets be formalised as soon as practicable to encourage early action investment in this area. Where rules are not fully developed (for specific offset project types), they can be introduced at a later date. An offset register should be set up immediately.

International Kyoto compliant offsets should also be included, without limits, in an Australian ETS (this will be necessary if international linkages to other schemes is to be encouraged). As a signatory of the Kyoto Protocol, Australia should abide by the rules surrounding the creation of VERs and ERUs.

Point of Obligation

This should be managed where practical and efficient.

Permit Issuance (Allocation)

Permit allocation to the generation sector has been one of the hotly debated policy issues of the ETS. Griffin strongly believes in a targeted free allocation of permits to compensate those generators that suffer a disproportionate loss in asset value as the result of the introduction of an ETS (as described under the previous PM Task Group and NETT schemes).

The argument has been made that as the Australian generation sector is not trade exposed; and since economic theory suggests that the permit allocation methodology (i.e. freely allocated or auctioned) should not affect the behaviour of these generators, then the relative efficiencies of generators should not be of consequence. While any industry can claim that each participant in that industry has a different emission profile and will be affected by a carbon price to different degrees, the generation sector can genuinely claim differentiation by generation type as a valid methodology for the targeted free allocation of permits. Electricity production comprises a complex mix of generating asset types, where each has a different role in producing the base-load, mid-merit and peaking power that a system requires. *Regulated electricity*

markets and investment decisions within these markets are thus based on the interaction between the different capital and operating costs of these assets. For example - in WA, the market operator (IMO) pays a capacity charge per MW based on the capital cost of constructing an OCGT power station. Coal-fired power stations (with much higher capital costs) are able to compensate for this low capacity payment by generating energy in very high proportions (over 90% capacity factors) and receiving the bulk of their revenue through energy payments. The result of a price on emissions (in fact, one of the points of a carbon price signal) is to reduce the competitiveness of higher emission intensive assets. This means that energy from coal based generators will be displaced by less GHG intensive forms of generation (coal based generators will not be able to pass the full cost of carbon through to consumers and so their higher cost of production will push them down the merit dispatch order). So an ETS purposely alters the fundamental structure of energy supply markets; and generation assets with higher emissions profiles (where investments in these assets were made in good faith under a previously understood market structure), will suffer a loss in asset value disproportionate to the rest of the economy.

An outcome of an ETS will be to eventually drive out highly emission intensive assets (built when the externalities of their emissions were not priced) and replace them with low-emission technologies (such as carbon capture and storage, nuclear and base-load renewables). These types of low-emission technologies do not exist in any current form that would enable investment within the next 10 to 15 years (perhaps longer). Even with government assistance, low-emission base-load technologies will require significant capital investments from the private sector. By not compensating those investors for the loss in asset value due to the introduction of an ETS (and thus increasing the sovereign risk premium), the cost of building new low-emission assets will increase, leading to inefficient increases to electricity costs (as opposed to cost increases predicated on emissions). Also, assuming that the owners of current generation assets are the most likely investors in future low-emission generation assets; then introducing the additional cash-flow burden of purchasing all permits through auction will reduce their ability to fund such investments.

Much has been made of the experience of freely allocated permits in the EU ETS. The overly simplistic view that the first period of the EU ETS was a failure should not dissuade Australian policy makers from properly accounting for the market distortions of an ETS through a targeted free allocation to affected generators. There are a few fundamental differences in the methodology for freely allocated permits proposed under the concept of 'disproportionate loss of asset value' and the manner in which it was managed in the first period of the EU ETS. To start with, poor emission data meant that permits equal to greater than 100% of emissions were allocated. This in itself would lead to the collapse of any rationing based scheme. And importantly, permits were allocated without bias to the likely (and purposely induced) effects an ETS was to have on electricity markets. This greatly reduced the structural impact of an ETS and meant that all generators sought to recoup the rent value of their permits by passing through the opportunity cost to consumers. A targeted free allocation of permits under a 'disproportionate loss of asset value' paradigm seeks only to compensate value destroyed from investments made in good faith and will be based

on detailed modelling (where such modelling suggests the free allocation required would be significantly less than 100% of emissions). While this may add a degree of complexity to the introduction of an ETS, it should be a once off requirement for a small group of identifiable participants that can be managed in a cost effective and transparent manner in an economy such as Australia. The consequences of not undertaking this process are high.

International Linkages

GHG emissions reduction requires a coordinated global response. An Australian ETS should be designed to link, where possible, to similar schemes where both emissions data and abatement is verifiable and consistent with Australian (or Kyoto) requirements.

Price Controls

Griffin does not see any benefit to capping permit prices.

Inter-temporality

Permits (and eligible offsets) should be time-stamped and be eligible for acquittal from the year of creation. Banking of permits (and offsets) should also be allowed. Like other financial instruments conveying a right which is of value to the owner, individual proponents should be best placed to make decisions on when to acquit or trade permits. Generally, Griffin opposes the borrowing of permits, unless in quantities used to reconcile small 'unders and overs' in each accounting period. This will have implications on compliance and penalties.

Treatment of TEEIIs

This represents a significant policy issue. As stated previously, a balance must be achieved in incentivising GHG emission reductions and maintaining competitiveness in Australia's emission intensive resources industries. While inherently emissions intensive, Australian operations are comparatively efficient within many of these industries. Reducing the competitiveness of Australian operations relative to international competitors will only serve to damage the Australian economy while increase global GHG emissions as less emissions efficient jurisdictions increase output. This would be a very counter-productive outcome.

The issues around how to define TEEIIs are complex. Strict definitions around what constitutes both 'trade exposed' and 'energy intensive' will necessarily lead to some operations being included and others not. Griffin envisages particular difficulty in identifying mid-level and small manufacturing operations that compete locally with low cost imports which will suffer higher costs due to secondary price rises from inputs such as electricity, transport and materials. Thought should be given to direct support through permit revenue in such circumstances.

Financial assistance should be in the form of permits rather than cash. Permits should be allocated across an accounting period, rather than in a lump sum, to avoid cash-flow issues. Individual proponents should be able to manage (trade or acquit) their

freely allocated permits as they see fit. Proponents should be able to opt to receive cash in lieu of permits at a market based (strike) price. This will help to reduce transaction costs for smaller organisations that would not otherwise be involved in the permit market.

Governance

The structure of governance will play an important role in the future effectiveness of an ETS. Currently, the policy framework is being set by the federal Government with significant input from the States via COAG. This is an appropriate methodology for Australia's federated structure. However, once the overarching policy has been set, the administration of the scheme should be taken out of the hands of Government. An independent administrator (likened to the Reserve bank in the Review), should be responsible for the ongoing administration of the scheme. Importantly, this should include responsibility for the annual (re)setting of 10 year firm and 10 year banded emissions target trajectories – in line with a narrowly defined legislative remit. In this way, just as the Reserve Bank is able to focus on core inflation (and not the political implications of how its monetary policy affects different jurisdictions in different ways), an independent carbon regulator will be more likely to establish the confidence and certainty required for long-lived investments, through making decisions based on legislative arrangements around long-term emissions objectives.

Compliance and Penalty

Compliance in such schemes is normally encouraged by penalties for non-compliance. A 'make good' provision should be included in the penalty to insure the integrity of the emissions cap.

Use of Permit Revenue

If the majority of permits are to be auctioned, which is a position advocated by Griffin, then significant revenue will be available to the Government to redistribute into the economy. While revenue from an ETS will be derived from emitters purchasing the right to emit from Government, most of the costs from an ETS will be passed on to the consumer, either through direct cost increases, secondary cost increases or reduction in economic activity. Effectively, this means a wealth transfer from consumers to Government (unfortunately, as with most financial markets, transaction costs and third party intervention means some of this wealth will be allocated to non-emission reducing uses which will affect the overall efficiency of the price signal). Griffin believes that Government should redistribute this wealth back to segments of the economy where it will be most efficiently used. This may include reducing inefficient taxes, spending on efficient infrastructure (such as public transport systems) or supporting low-income households. Directly subsidising parts of the economy affected by an ETS should be structured in a rigid manner (such as allocation for TEEIs). The potential for 'pork barrelling' on politically expedient terms should be minimised.

Griffin strongly encourages a significant proportion of ETS revenue to be allocated to the development and commercialisation of low-emission technologies, particularly in

stationary generation and transport. The earlier new low-emission technology can be introduced to the economy the more effective the initial cost impost of the carbon price signal will become (as longer term price trajectories will decrease faster).

Griffin understands that the consultation process required to implement an ETS will require interactive engagement between Government and industry. Griffin is happy to continue to be part of this process and looks forward to the outcome of the current discussion paper.

Should you have any questions regarding our comments, please contact:
Shane Cremin, Market Development Manager, Griffin Energy, 08 9261 2908.

Yours Sincerely,

A handwritten signature in black ink, appearing to read 'W. Trumble', with a long horizontal flourish extending to the right.

Wayne Trumble
EGM Power Generation