Executive Summary

Introduction to OneSteel

OneSteel is the largest manufacturer of steel long products, and the leading metals distribution company in Australia with revenues of over $6 billion Australian dollars. OneSteel has over 200 operational sites in Australia and New Zealand, and more than 10 offshore locations in Asia, USA and UK.

Following its merger with Smorgon Steel in August 2007, OneSteel's primary operations include mining, steelmaking, the manufacture of intermediate and finished steel products, metal scrap recycling and the distribution and sale of metal products. OneSteel manufactures and distributes structural, rail, rod, merchant bar, cold finished bar, chrome plated bar, reinforcing, grinding media, rail wheels and axles, coated steel sheet, wire, tube and pipeline steel products. OneSteel employs over 10,000 people.

Its energy and greenhouse intensive facilities include an iron ore based steelworks at Whyalla, and scrap steel based Electric Arc Furnace steelmaking facilities in Sydney (Rooty Hill), Melbourne (Laverton) and Newcastle (Waratah), which feed downstream steel processing and distribution sites. The business is highly vertically integrated.

OneSteel's response to the Garnaut Climate Change Review Emissions Trading Scheme Discussion Paper complements previous public submissions to the Inter-Jurisdictional Working Group on Emissions Trading, and the Prime Ministers Taskforce on Emissions Trading in between 2005 and 2007. Accordingly, OneSteel's response focuses principally on design issues raised by the Garnaut Climate Change Discussion Paper.

Key Messages and Issues

Given the complexity and magnitude of addressing detail in designing an ETS, we believe it is important for each of our points listed under Responses to Specific Design Issues to be reviewed by the Garnaut Climate Change Review Secretariat rather than only the Executive Summary.

The key issues and messages of this submission are:

- OneSteel recognises the importance of climate change as a global issue and favours market based mechanisms such as emissions trading schemes over carbon taxes as one of the tools available to address the issue. However, OneSteel emphasises that the company's response to items raised in the Discussion Paper should not be construed as endorsement of a particular approach within an ETS design; rather it is OneSteel's intention to provide its opinions and questions against the proposals put forward in the Paper such that an informed evaluation occurs on the merits and impacts on ETS design.

  In many instances, further information is required on the design proposals put forward in the paper to allow OneSteel (and other stakeholders) to undertake a thorough analysis of impacts, and form considered, independent positions for later comment. OneSteel emphasises that the designers of an Australian ETS must allow sufficient time within the ETS consultation processes for companies to undertake independent analysis on the detailed design elements of

any ETS proposal. It is noted that 3 to 4 weeks to analyse, model and comment is insufficient. OneSteel recognises that the Australian Federal Government has committed to introducing a domestic emissions trading scheme by 2010. Like all designer markets, there can be considerable variation in emissions trading scheme design, and accordingly considerable variability in the outcomes of alternative designs. It is OneSteel's view that a specific emissions trading scheme design should implemented after it has been comprehensively analysed, and deemed to be the best scheme type to meet the national interest. This assessment should involve a formal Regulatory Impact Statement (RIS).

- Any ETS should only be introduced with the full support and involvement of all levels of Government, in order to ensure such a scheme is equitable and consistent across State jurisdictions, long-lasting and adequately funded.

- The Australian iron and steel industry has significant trade exposure under an ETS as a number of developing economies that are subject to less stringent greenhouse constraints than Australia are also significant iron and steel producers. A discrepancy in greenhouse gas policy would place the Australian iron and steel industry at a significant disadvantage relative to its international competitors.

  This could potentially lead to the migration of iron and steel production to countries with no or relatively liberal greenhouse gas emissions constraints. This would result in a counterproductive increase in greenhouse gas emissions associated with the production of steel, and transportation of iron ore and finished steel. It is critical that any ETS includes robust measures to protect the competitiveness of trade-exposed companies, taking into account companies' individual circumstances.

- Emissions trading of itself may well be insufficient to achieve significant emissions reductions required to meet the challenges presented by climate change. With respect to the Steel Industry, the two major technologies for steel production - integrated steelmaking and electric arc furnace steelmaking – are mature. There are no commercial technologies on the immediate horizon to replace these existing processes. The development and commercialisation of new technologies required to meet this challenge will require other targeted policy measures.

- The stated objective of an ETS in terms of transaction space definition is not appropriate. It is important for the developers of emissions trading schemes not to lose sight of the reality that any emission market should simply be a tool at the disposal of regulators to encourage the least cost emissions abatement. Any transactional space should focus on the needs of those companies which will be required to reduce emissions over time, rather than the desires of peripheral market participants who look to emissions trade as a means of making money or financial portfolio diversification.

- Scheme analysis and consultation should necessarily consider both the likely sectoral impacts of the measure and the likely costs of action and inaction on this issue. This process is expected to be informed by other work being undertaken by the Garnaut Climate Change Review and others. OneSteel believes that special consideration of emissions intensive trade exposed companies goes someway to meeting this objective but further consideration of

national interest is warranted on all potential elements of scheme design and operation such as allocation, and the distribution or reinvestment of auction and penalty revenues.

- Although the Discussion Paper recommends special treatment for emissions intensive trade exposed companies, any such treatment is likely to be benchmarked against emission reduction or efficiency improvements. To this end, the proposed five-year permit forward price curve is too short a time horizon when considering the long lived and capital intensive nature of many of Australia's emissions intensive trade exposed companies. It will not provide sufficient certainty when planning new projects or upgrades to existing projects. The Discussion Paper does not explicitly state how limits or caps should be related to scheme coverage. It is OneSteel's position that the coverage of the scheme should be as wide as possible within the bounds of technical measurement, and that the covered sectors should only be responsible for the relative proportion of the national emission limits. The emission reduction burden should not be placed exclusively on the covered sectors, and those covered sectors should not be responsible for meeting Australia's entire reduction goal. Any designers of an Australian ETS should consider the use of firm caps, gateways, and indicative paths as described in prior work by the National Emissions Trading Taskforce and the Prime Ministers Task Group on Emissions Trading. Such approaches may offer a suitable method to balance industries need to have longer-term certainty with the Government's need to maintain flexibility.

- OneSteel supports the Discussion Paper's proposal that the initial scheme trajectory should follow Australia's international commitments under the Kyoto Protocol. This introductory period with emissions limits close to or at expected business as usual projections is fundamental in reducing the risk of price shocks during the schemes initial operational period.

- OneSteel supports the incorporation of a broad range of offsets on the provision that offsetting activities can demonstrate a measurable reduction in greenhouse gas emissions. To preserve the integrity of the system any domestic offset mechanism must be supported by rigorous and transparent verification and certification procedures. In addition, OneSteel believes that the incorporation of offsets from other international schemes (e.g. through recognition of Certified Emissions Reductions - CERs under the Clean Development Mechanism - CDM) provides an avenue for linkage, and should be explored.

- The Discussion Paper proposes to place the point of obligation primarily at the point of direct emission, but also suggests the option of either upstream or downstream to lower transaction costs. The proposal fails to nominate a suitable materiality point for the inclusion of direct emissions. This is a critical element of scheme design, and should preferably be aligned with existing inventory approaches that are being developed under the auspices of the National Greenhouse and Energy Reporting Act

- OneSteel has previously supported the notion of allocation to non-trade exposed companies based on disproportionate loss (subject to further details relating to implementation). Importantly, it was OneSteel's position that permits (and any offsets created under the scheme rules) must embody property rights with legislative certainty of compensation in the event that the scheme rules are changed in a way that fundamentally changes their value. Considering the auction process is likely to raise many billions of dollars, any recommendation regarding auctioning should be supported by a comprehensive analysis of

economics, practicalities, and ability to achieve the national objective in an equitable manner. Furthermore, any such auction should be designed in a way to ensure that parties (financial institutions, investors etc) with no direct greenhouse obligation are not able to game or control the market such that a significant revenue stream is diverted away from the scheme rather than use within the scheme in reducing national greenhouse gas emissions. In the absence of this detailed supporting analysis, OneSteel does not support abandoning free allocation if it is likely to create avoidable volatility and costs in energy markets, and exposure of OneSteel to imported products with no carbon cost burden.

- Any linkages must only be progressed after careful consideration of the impacts on permit prices and pool availability. Linkage of an ETS with other international schemes could be complicated by potentially significant pricing differentials between schemes. One issue is that higher process/penalties overseas could see local greenhouse credits/permits being quickly obtained by overseas companies, to the detriment of local industry.

- OneSteel strongly supports the establishment of credible institutional arrangements and penalties that support the operation of an ETS. The scheme must be revenue neutral; it should not generate revenue for the Government beyond administrative costs. Any revenues above administration cost need to be recycled into programs and complimentary measures that support greenhouse reduction and hence lower the burden on industry and taxpayer, and assist in achieving national reduction targets. The objective of the government is to reduce greenhouse, not make money out of it. Any administrative body that is given the responsibility for managing the scheme finances must be guided by strict principles.

Responses to Specific Design Issues

Section 2.1 – The Objective of an ETS

The discussion paper states that the singular objective of the scheme should be:

> *"To provide a transactional space that enables the transmission of permits to economic agents for whom they represent the greatest economic value"*

While OneSteel appreciates the intent and the importance of efficient, low cost and transparent markets, it is important for the developers of emissions trading schemes not to lose sight of the reality that any emission market should simply be a tool at the disposal of regulators to encourage the least cost emissions abatement. This being the case, designers of an Australian ETS need to appreciate that any transactional space should focus on the needs of those companies which will be required to reduce emissions over time, rather than the desires of peripheral market participants who look to emissions trade as a means of making money or financial portfolio diversification.

To this end, any framework put in place to provide any such transactional space should be constructed through comprehensive analysis and consultation to minimise perverse outcomes. Importantly the "transactional space" should exist simply to facilitate the deployment of least cost abatement to meet emissions reduction policy outcomes.

Section 2.3 Extrinsic Design Features of an ETS addressing Multiple Policy Features

The Discussion Paper has suggested extrinsic features that may require a trade off between economic, social, and environmental policy objectives.

In addition to these identified features, the designers of an ETS should also consider the impact of the scheme on the various parameters pertaining to the national interest. The national interest includes understanding of sectoral issues and opportunities that relate to optimum scheme design. The national interest also includes the costs and impacts of action and inaction of greenhouse.

The implementation of an ETS should only proceed after comprehensive analysis and consultation on the specific design parameters of the proposed scheme has deemed the scheme to optimum in terms of the national interest. Any such analysis and consultation should necessarily consider both the likely sectoral impacts of the measure and the likely costs of action and inaction on this issue. This process is expected to be informed by other work being undertaken by the Garnaut Climate Change Review and others.

OneSteel believes that special consideration of emissions intensive trade exposed companies goes someway to meeting this objective but further consideration of national interest is warranted on all potential elements of scheme design and operation such as allocation, and the distribution or reinvestment of auction and penalty revenues.

Section 3.3 – Establishing the Emissions Limit

The Discussion Paper describes the alternatives in expressing emission limits over time.

OneSteel agrees in principle with the target reflecting both the need to meet international agreements and an emission reduction opportunity set which will evolve over time. In setting the emission trajectories OneSteel believes that the following points should also be considered:

- Policy makers should be mindful that stringent reduction targets in Australia are unlikely to have any significant impact on global greenhouse gas emissions in the absence of similar targets in all major emitting countries (both developed and developing). This notion should be applied when considering linking increasingly stringent domestic trajectories with the introduction of similar schemes internationally. Importantly the criteria for moving to the more stringent trajectories must include both developed and developing major emitting countries.

- In setting emission limits finding a balance between certainty and flexibility will be one of the most challenging responsibilities of regulators administering an Australian ETS. In proposing a period of certain emission limits, the designers of an ETS need to appreciate that five years is too short a time horizon when considering long lived and capital intensive nature of many of Australia's emissions intensive trade exposed companies. Although the Discussion Paper recommends special treatment for emissions intensive trade exposed companies, any such treatment is likely to be benchmarked against emission reduction or efficiency improvements. To this end, a five year permit forward price curve will not provide many companies who own and invest in long-lived emissions intensive ventures sufficient certainty when planning new projects or upgrades to existing projects. The Discussion Paper does not explicitly state how limits or caps should be related to scheme coverage. It is OneSteel's position that the coverage of the scheme should be as wide as possible within the bounds of technical measurement, and that the covered sectors should only responsible for the relative proportion of the national emission limits. The emission reduction burden should not be placed exclusively on the covered sectors, and those covered sectors should not be responsible for meeting Australia's entire reduction goal.

- Any designers of an Australian ETS should consider the use of firm caps, gateways, and indicative paths as described in prior work by the National Emissions Trading Taskforce and the Prime Ministers Task Group on Emissions Trading. Such approaches may offer a suitable method to balance industries need to have longer term certainty with the Government's need to maintain flexibility.

- OneSteel supports the Discussion Paper's proposal that the initial scheme trajectory should follow Australia's international commitments under the Kyoto Protocol. Based on the emissions forecasts released in the Department of Climate Change Tracking the Target 2007, an ETS trajectory based on the 108% commitment outlined in the Kyoto Protocol would require Australian business to simply maintain business as usual activities. This introductory period with emissions limits close to or at expected business as usual projections is fundamental in reducing the risk of price shocks during the schemes initial operational period. Importantly, following this approach acknowledges the short term emissions growth momentum which needs to be accommodated in the near term to maintain continuity of

service provision in sectors such as electricity, which would consequently impact trade exposed value added manufacturing activities such as electric steelmaking. A slow start to any ETS would additionally give companies time to develop the internal systems required to include carbon into marginal pricing decisions, and importantly reduce the potential short-term volatility during introduction of the scheme.

Section 3.4 - To whom will the ETS apply?

The Discussion paper outlines a recommended approach to scheme coverage, domestic offsets, and point of liability. On the recommended positions suggested by the Discussion Paper OneSteel makes the following points:

- OneSteel supports the application of an ETS to a broad base, so long as emission contributions can be accurately estimated or measured. To this end further analysis is required to assess whether sectors such as forestry should be excluded from the schemes inception. The statements in the Discussion Paper concerning the ability to account for forestry greenhouse appear incongruent with current public statements and reports from both the Australian Department of Climate Change and Forestry sector.

- OneSteel supports the incorporation of a broad range of offsets on the provision that offsetting activities can demonstrate a measurable reduction in greenhouse gas emissions. To preserve the integrity of the system any domestic offset mechanism must be supported by rigorous and transparent verification and certification procedures. In addition, OneSteel believes that the incorporation of offsets from other international schemes (e.g. through recognition of Certified Emissions Reductions - CERs under the Clean Development Mechanism - CDM) provides an avenue for linkage, and should be explored. It is acknowledged that the legitimacy of some offset created under the Clean Development Mechanism are questioned but in designing an Australian ETS any offset which can be used by the Australian Government to meet its international obligations should be considered by default as compliant with the requirements of a domestic ETS. Consequently, there should not be any limitation on the use of international offsets such as CERs to meet domestic obligations.

- Any designer of an Australian ETS should explicitly consider the interaction and transitional arrangements of existing state based schemes such as the NSW Greenhouse Gas Benchmarking Scheme when planning the design and implementation of a new cap-and – trade mechanism.

- The Discussion Paper proposes to place the point of obligation primarily at the point of direct emission, but also suggests the option of either upstream or downstream to lower transaction costs. The proposal fails to nominate a suitable materiality point for the inclusion of direct emissions. This is a critical element of scheme design, and should preferably be aligned with existing inventory approaches that are being developed under the auspices of the National Greenhouse and Energy Reporting Act. For example, it may be suitable that activities with direct emissions greater than 25,000 t CO2-e are applied a direct liability, with all smaller activities having liabilities placed upstream on fuel suppliers. Those corporations who have a number of smaller activities (which would normally face an indirect upstream emissions

obligation) should have the opportunity to choose to opt into the scheme and directly manage their aggregate liabilities.

Section 3.5 - Releasing permits into the market

The Discussion Paper goes further than previous papers by the Inter-Jurisdictional Working Group and the Prime Minister's Taskforce on Emission Trading by rejecting the notion of any compensation via free allocations to non-trade exposed liable parties, and a recommendation of full auctioning.

OneSteel has previously supported the notion of allocation to non-trade exposed companies based on disproportionate loss (subject to further details relating to implementation). Importantly, it was OneSteel's position that permits (and any offsets created under the scheme rules) must embody property rights with legislative certainty of compensation in the event that the scheme rules are changed in a way that fundamentally changes their value.

OneSteel would only support abandoning free allocations to non-trade exposed companies based on comprehensive analysis and consultation to minimise perverse outcomes. The information provided in the Garnaut Climate Change Emissions Trading Discussion Paper provides an interesting perspective on the potential role and benefits of full auctioning, but is not supported by sufficient independent analysis of the likely impacts to allow OneSteel to support such a proposal. Furthermore, the submission period is not sufficiently long for OneSteel to commission independent analysis into the likely impacts of full auctioning to non-trade exposed liable parties.

Considering the auction process is likely to raise many billions of dollars, any recommendation regarding auctioning should be supported by a comprehensive analysis of economics, practicalities, and ability to achieve the national objective in an equitable manner. Furthermore, any such auction should be designed in a way to ensure that parties (financial institutions, investors etc) with no direct greenhouse obligation are not able to game or control the market such that a significant revenue stream is diverted away from the scheme rather than use within the scheme in reducing national greenhouse gas emissions.

In the absence of this detailed supporting analysis, OneSteel does not support abandoning free allocation if it is likely to create avoidable volatility and costs in energy markets, and exposure of OneSteel to imported products with no carbon cost burden.

If any scheme developer was to pursue full auctioning to non-trade exposed liable parties, they should do so only after undertaking comprehensive independent analysis of Australia's energy supply markets (both electricity and gas) including an assessment of the likely impacts of full auctioning on both

Section 3.6 - International Links

As detailed in previous submissions, OneSteel has the following positions on linking an Australian ETS to similar but subtly different international emissions trading schemes:

- While it is recognised that international collaboration can be as important as borrowing in reducing volatility, any linkage must be aimed at reducing domestic compliance costs.

- Any linkages must only be progressed after careful consideration of the impacts on permit prices and pool availability. Linkage of an ETS with other international schemes (such as the European Union Emissions Trading Scheme or the US Regional Greenhouse Gas Initiative) could be complicated by potentially significant pricing differentials between schemes. One issue is that higher process/penalties overseas could see local greenhouse credits/permits being quickly obtained by overseas companies, to the detriment of local industry.

- Incorporation of offsets from other international schemes provides an avenue for linkage, and should be explored. (e.g. through recognition of Certified Emissions Reductions - CERs under the Clean Development Mechanism - CDM).

Section 3.8 - Avoiding distortion in trade-exposed, emissions-intensive industries (TEEIIs)

The Australian iron and steel industry has significant trade exposure under an ETS as a number of developing economies that are subject to less stringent greenhouse constraints than Australia are also significant iron and steel producers. This discrepancy in greenhouse gas policy stringency would place the Australian iron and steel industry at a significant disadvantage relative to its international competitors.

This could potentially lead to the migration of iron and steel production to countries with no or relatively liberal greenhouse gas emissions constraints.

This could result in a counterproductive increase in greenhouse gas emissions associated with the transportation of iron ore and finished steel.

Measures to protect the competitiveness of trade-exposed companies must be included, taking into account companies' individual circumstances.

OneSteel strongly supports special consideration being given to emissions intensive trade exposed companies. Subject to further details relating to ETS design and implementation, OneSteel supports this special consideration being in the form of compensation. OneSteel makes the following comments regarding the propositions of such treatment as outlined in the Discussion Paper:

- OneSteel strongly supports a robust compensation mechanism to trade exposed industry sectors, but acknowledges that such compensation must balance the need to get it right versus complexity. The proposed mechanism using international benchmark prices to quantify compensation requirements may have some merit but is likely to be highly complex to administer considering the vast array of product types and sub-types manufactured by Australia's trade exposed emissions intensive companies.

- OneSteel notes the Discussion Paper's departure from the common "energy intensive" description of TEEI's to the term *Trade Exposed Emissions Intensive*. Although not explicitly discussed in the paper, we assume that in assessing the impact of an emissions trading scheme on trade-exposed businesses both direct and indirect cost impacts are to be assessed. These indirect cost impacts should include not only increased costs of electricity, gas, and coal, but also essential manufacturing inputs such as oxygen, zinc, etc which due to their greenhouse intensive nature are likely to also increase in cost. It is OneSteel's position that a

compensation measure for Trade Exposed Emissions Intensive companies should include the impact of both direct and indirect emissions.

- OneSteel notes the Discussion Paper fails to nominate a proposed definition of exposure materiality. While it is acknowledged that this is a level of detail beyond the intent of the Discussion Paper, it should be noted that the exact definition of emissions intensive materiality may have significant bearing on the applicability of the compensation measure to a number of Australia's trade exposed companies. With this in mind, OneSteel wishes to work with regulators or scheme designers to ensure that the measurement of materiality is appropriate.

- The Discussion Paper proposes an assessment of trade exposure based on actual international prices and potential prices if competitor countries applied energy or carbon prices similar to those experienced in Australia. This approach in examining impacts on overseas products, rather than directly examining impact on domestic product prices compared to international pricing, is likely to become particularly complex considering the vast diversity in manufacturing techniques and energy bases in competitor countries. In addition, any such assessment should also include the greenhouse and energy associated with transport of similar product into the Australian markets.

- The Discussion Paper notes that compensation payments should be "*timed as close as possible to contemporaneously with the loss of revenues*". Practically the nature and timing of assessments and the compensation resultant from assessments can have significant impacts on the financial performance of organisations particularly in the first year of scheme operation. OneSteel wishes to highlight the importance of having specific consultation with trade exposed emissions intensive companies on the operation of assessments and timing to ensure that temporal impacts (if any) are clearly communicated to shareholders well in advance to the ETS implementation.

- At this time OneSteel does not have clear preference for compensation to be in the form of either cash or permits, but can see merit in allowing companies who are eligible for compensation to choose cash, permits or perhaps a mix of permits to cover direct obligations (adjusted for efficiency) and cash to cover indirect impacts.

Section 3.9 - Governance

OneSteel strongly supports the establishment of credible institutional arrangements and penalties that support the operation of an ETS and makes the following comments regarding the proposals outlined in the Discussion Paper:

- OneSteel recognises the need for a number of the regulatory functions associated with the ETS to be transferred to an independent group. The analogy with the Reserve Bank is noted but it is likely that the responsibilities of an Independent Carbon Bank will be considerably different to those of the Reserve Bank. Importantly the Reserve Bank does not act as a facilitator of revenue raising from industry to the Government or compensation distribution.

- The scheme must be revenue neutral; it should not generate revenue for the Government beyond administrative costs. Any revenues above administration cost need to be recycled into programs and complimentary measures that support greenhouse reduction and hence lower

the burden on industry and taxpayer, and assist in achieving national reduction targets. Experience indicates that governments direct revenues from similar schemes into consolidated revenue, hence becoming an indirect tax and devaluing the objectives of any proposed scheme. The objective of the government is to reduce greenhouse, not make money out of it. Any administrative body that is given the responsibility for managing the scheme finances must be guided by strict principles.

The governance rules, transparency and independence around decision-making in directing revenue requires detailed work, as does the guidelines on investing monies (e.g. where money held and dividends accrued whilst decisions on allocations being made). OneSteel is concerned about the option put forward that monies could be directed to infrastructure projects, in that it is possible that improper or poorly assessed cases could be put up by federal and state governments under the guise of greenhouse reduction to direct funds to infrastructure projects that should be funded by other "business as usual" government revenues.

- OneSteel supports, in principle, a penalty set at the maximum marginal cost of abatement expected to be required to meet the emission limit in addition to the government using penalty monies to purchase abatement on behalf of non-compliant liable parties. Under this approach if companies find that that are unable to establish the required infrastructure and procedures required to manage a liability, they can simply pay the government to manage their liabilities on their behalf. This becomes a simple transaction akin to a tax for companies who are unable to use the flexibility of an ETS to manage their greenhouse gas liabilities.

- OneSteel supports the provision of a small degree of flexibility on the payment of penalties when liable parties are only marginally short in one period. OneSteel recommends that the designers of an Australian ETS consider implementing a penalty system with a feature similar to the NSW Greenhouse Gas Benchmarking Scheme that allows liable parties to choose to carry forward an allowable shortfall of for example up to 10% of their annual liability. If shortfalls were passed forward these shortfalls must be made good in subsequent periods.

Section 5.7 - Macro-economic adjustments associated with introduction of the ETS

It is possible that the impact of introduction of the ETS is large enough to have implications for macro-economic stability. These short term impacts need to be considered when introducing an ETS during a global credit crunch. Importantly scheme designers need to carefully plan the introduction of any scheme to minimise shocks to macro-economic factors such as inflation, which when combined with the impacts of the global credit crunch.

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