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TITLE: **What nobody wants to say about the carbon tax package**

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Over the past 12 months, the political debate over whether the carbon price is a tax or an emissions trading scheme has been as brutal as it has been boring. Rather than explain the details of what is, in fact, a hybrid scheme, the government, opposition and media have instead busied themselves in the politics of broken promises, minority government and the inherent conflict between the need to compromise and the need to stand on principle.

In a couple of years, when the political hysteria dies down, it will be necessary to analyse the actual policy that has been passed in order to either (depending on your faith in science and economics) make it better or tear it down. And when that day comes, most people will probably be quite surprised at what they find. Put politely, the clean energy future package contains a surprising number of contradictory mechanisms and objectives which, in time, will need to be streamlined and reconciled.

Before detailing seven of its major contradictions, it is important to state at the outset that, while the government's package has a number of deficiencies, it is better to have a price on pollution than not. The measures that have been established should be seen as a starting point and, irrespective of who wins the next election, they will evolve through time. Our interest in identifying these contradictions is not to suggest that the clean energy future package is not worth having; merely that it will need an overhaul if it is to be cost-effective.

1. *Complementary renewable energy policies*. Under the clean energy future package, there are two major "complementary" renewable energy policies, the Renewable Energy Target (RET) and the Clean Energy Finance Corporation (CEFC). They pull in opposite directions and neither seems focused on accelerating the decline in the cost of alternative technologies. The RET sets a target of increasing the proportion of electricity from renewable sources to 20% by 2020 and uses tradeable certificates to incentivise the deployment of least-cost renewables (typically wind) to meet it.

The CEFC adopts the opposite approach. It is looking to invest in a cross-section of technologies in order to realise the nebulous objective of applying "capital through a commercial filter to facilitate increased flows of finance into the clean energy sector thus preparing and positioning the Australian economy and industry for a cleaner energy future".

With current policy settings, CEFC spending on renewables is unlikely to increase renewable electricity generation (that is, it won't result in more renewable electricity than was already required under the 20% RET target). Rather, it will merely change the type of renewable technologies that are used to meet the target. In doing so, it works against the object of the RET to deploy least cost renewables.

The tensions between the CEFC and RET are indicative of the contradictions that exist between (and within) all current federal, state and local government renewable energy instruments. Steps need to be taken to rationalise the existing mechanisms to ensure they achieve a coherent policy objective. At the moment, most seem merely to be facilitating the import and deployment of foreign-made technologies, without producing material greenhouse, cost-reduction or industry benefits.

2. *Fossil fuel subsidies*. We have been told repeatedly that we need a price on carbon to drive least-cost abatement by making firms and individuals face the full cost of their decisions. Yet, at the same time, we provide subsidies for fossil fuel use and extraction of around $10 billion per year, which is similar in magnitude to the carbon price. Hence, we have two policy instruments pulling in opposite directions. While the subsidies remain, the clean energy future package has no chance of cutting emissions in the cheapest way possible. By cutting these subsidies, the government could simultaneously improve its budget position and the efficiency of its carbon policies.

3. *Exemptions from carbon liabilities*. Quite rightly, the government and others have stated that the pricing scheme should be as broad as possible in order to reduce the cost of abatement. Despite this, the scheme leaves out emissions from several significant sources, including those associated with passenger and light commercial vehicles, trucks, agriculture and deforestation. Over 30% of Australia's emissions are excluded from the carbon pricing mechanisms. The exclusion of most passenger transport emissions is particularly egregious — this was originally justified on the basis of the spike in world oil prices in 2008, a spike that has since faded away.

4. *Industry assistance, compensation and subsidies*. A much commented on aspect of the clean energy future package is the industry assistance provided to polluters. The majority of this is directed at four groups: coal-fired electricity generators (roughly $5 billion, mostly through the Energy Security Fund), emissions-intensive, trade-exposed industries ($9 billion in the first three years alone through the Jobs and Competitiveness Program), coal mines ($1.26 billion through the Coal Sector Jobs Package and a further $70 million in the Coal Mining Abatement Technology Support Package) and the steel industry ($300 million through the Steel Transformation Plan). The amount of assistance offered to these groups is excessive and inequitable. Because much of it is linked to production, it will also impede efficient reform.

The amount going to coal-fired generators is a stand-out for its size and the fact that it lacks a compelling policy justification. Eligible generators will receive upfront cash payments of $1 billion, almost 42 million free carbon units per year from 2013-14 until 2016-17 (around 12% of all carbon units issued under the scheme during this period), and government loans to help them refinance and buy future year carbon units. So generous is the amount offered that it helped induced AGL to buyout Loy Lang A power station, one of Australia's largest

and most polluting brown coal generators. Propping up coal generators is the antithesis of a cost-effective path to a “clean energy future”.

The Jobs and Competitiveness Program is on firmer policy ground than the Energy Security Fund, as most acknowledge that there is a need for some mechanism to assist domestic polluters that compete with foreign producers that don’t face a carbon price. But size matters. The government package involves the provision of roughly 37% of all carbon units for free to trade-exposed industries. While some assistance was warranted, the net has been cast too wide.

5. *Price ceiling and price floor*. The government, industry groups and many others assert that the market should be left to determine the carbon price because it will reduce the cost of abatement. Despite this, the scheme has a fixed price for three years, followed by three years in which there will be both a price floor (starting at $15/tCO2-e) and ceiling (set at $20 above the expected international carbon price in 2015-16). The existence of the ceiling could undermine the incentives to invest in alternative technologies and impede efficient structural change.

Given the possibility of a medium-term international carbon price of around $5/tCO2-e, it is possible that, once emissions trading begins, the price ceiling could be as low as $25/tCO2-e, below the price in the third year of the fixed price period ($25.40). The price floor could have similar adverse impacts on efficiency and, to date, the government hasn’t provided a persuasive explanation for its existence. If it wants to provide price certainty to encourage investment, it should have gone with a carbon tax. Alternatively, it should have set the price floor for a period that reflects investment timeframes (three years is meaningless for most relevant investments). Another possibility is that the government has concerns about the environmental integrity of imported carbon credits and, therefore, wants to secure greater domestic abatement through a higher domestic price. If this is the case, a better solution would be to identify and exclude questionable international carbon credit types.

6. *Direct action or a market mechanism?* The government has told the public that it is on the side of market mechanisms because they are more efficient, and that direct action is the work of the devil because it is a centrally-controlled, soviet-style response. The opposition, on the other hand, has been spinning the tale that it is the party of practical direct action that will reduce emissions rather than shuffle paper. The reality is more complex. Reducing emissions cost-effectively requires a mix of market mechanisms and direct action and, despite their rhetoric, the policies of the government and opposition include aspects of both. The clean energy future package has an extensive list of direct action measures, including the buyout of 2000 megawatts of emissions-intensive coal-fired electricity generation capacity, $10 billion for the CEFC to spend on renewables, low-emission technology and energy efficiency, and $1.2 billion for the Industry Department to spend on energy efficiency and tech support.

On the other side, at the heart of the opposition’s direct action plan is a market mechanism (a baseline-and-credit emissions trading scheme), which will include one or more carbon prices (reflected in the abatement and penalty prices). Although technically a market mechanism, the opposition’s scheme ingeniously combines all of the negatives of standard direct action policies (uncertainty of environmental outcomes, high administrative cost,

opportunities for political manipulation) with none of the benefits of ordinary carbon pricing instruments.

The truth is that neither side has the balance right. The basic rules are that governments should use carbon pricing to do the heavy lifting on abatement and direct action where carbon pricing can't be applied cost-effectively (e.g. small polluters and forestry), where price signals fail to realise cheap abatement (e.g. residential energy efficiency), and where targeted investments can reduce costs by accelerating the decline in the price of low- and zero-emission technologies (e.g. renewable energy schemes).

7. *National emission target and the 2 degree target*. One of the objects of the Clean Energy Act is "to support the development of an effective global response to climate change, consistent with Australia's national interest in ensuring that average global temperatures increase by not more than 2 degrees above pre-industrial levels". At present, it looks as though Australia's 2020 emission reduction target will be a cut of 5% on 2000 levels; well short of an equitable contribution to a global effort to keep temperature increases to 2 degrees. Of course Australia cannot achieve the 2 degrees target on its own.

However, with its current policy settings, it can hardly say it is leading the charge to drive global change. What many have overlooked in the recent debate is that the carbon pricing scheme is merely a means of achieving the national emission target. The target will be the primary determinant of the environmental effectiveness of the clean energy future package and, at the moment, both of the major parties share the same deficient 5% objective.

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