

# THE BUSINESS OF DIRECT ACTION

Cameron Reid sets out where the business opportunities lie in Australia's Direct Action plan to reduce emissions

While variations on the phrase “sometimes the only thing you can change is your attitude” is generally the realm of self-help gurus, social media psychology and resilience coaches, it is also an apt summary of climate policy within the Australian context.

The recent high profile changes in Australian politics have not resulted in substantive changes to climate change policy. Yet, whether it be the change in leadership, cautious optimism in the lead up to the Paris climate talks or simply the onset of the southern spring, there is a tangible change in mood that can only be described as more optimistic and upbeat when referring to Australian climate and carbon policy. It is telling that responsibility for the environment and foreign affairs portfolios', pivotal areas in the lead up to the Paris conference, are two of only a handful that remained unchanged in the ministerial reshuffle in the wake of the leadership change.

Response to the Australian Intended Nationally Determined Contribution, a 26-28% reduction on 2005 emissions by 2030

## MUCH OF THE HEAVY LIFTING NEEDS TO BE DONE BY TWO CORE MECHANISMS THAT EFFECTIVELY CONSTITUTE THE DIRECT ACTION PLAN

has generated a (generally) healthy debate domestically about emission reduction targets and levels, what constitutes Australia's fair share and the economic opportunities, and risks and impacts that may flow from various outcomes. This debate will continue and intensify as Paris nears, running a real (albeit reduced) risk of politicisation. However, this necessary – but potentially distracting – debate is now less likely to overshadow the underlying task of reducing emission levels significantly over the coming years.

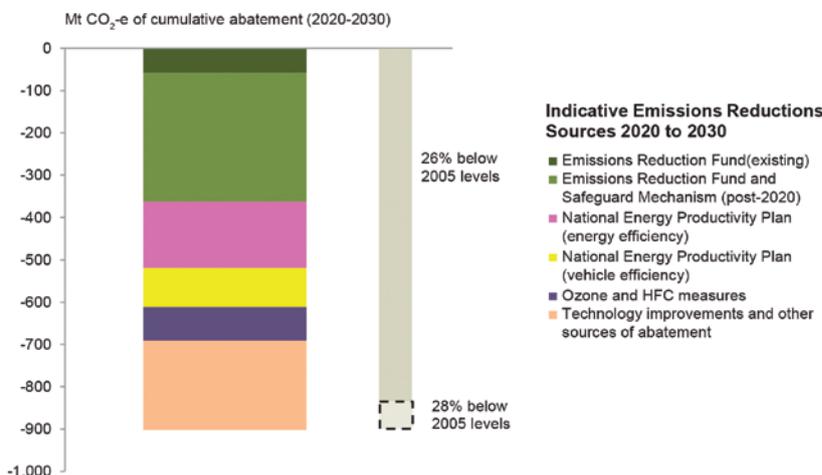
Government publications highlighting the path or policy mix currently designed to achieve the reduction target show the relative contributions of key programmes and policies. As you would expect, the government has necessarily sought to balance the desire for detail against the need to consult, refine and alter policy details and proportions in line with information as it comes to hand.

What we do know is that much of the heavy lifting needs to be done by two core mechanisms that effectively constitute the government's Direct Action plan (there are other initiatives, complementary to the reduction task, but of less materiality).

These two programmes, the Emission Reduction Fund (the ERF) and the Safeguard Mechanism, play two distinct roles. The first is a closed bid reverse auction process, designed to facilitate and enable emissions reduction across the economy by providing companies the opportunity to bid abatement into a periodic auction process. Critically the price the government pays per tonne of abatement achieved is “as bid”, designed to ensure the cheapest form of abatement, thus driving competitive pressure for firms to put in the cheapest but commercially viable price per tonne of CO<sub>2</sub> abated. Successful bids then in effect contract with the government for the delivery of the abatement and are paid on delivery, ensuring Australian taxpayers only pay for delivered abatement and through the design of the auction at the lowest price.

The second, the Safeguard Mechanism, in contrast, sets a baseline for the larger emitting facilities (those with annual emissions above 100,000 tCO<sub>2</sub>e) and provides for the constraint of emissions below their determined baseline. It is important to note that, at the time of writing in early October, the mechanism rules had just been released and were in the process of being legislated. Legislation has been available for public comment and the final legislation, while not guaranteed, appears likely.

An important element of the mechanism is to treat the electricity generation sector



Indicative emission reduction sources 2020-30. Source: Department of the Environment, Australia's 2030 Emissions Reduction Target

initially as a single entity, defining a “sectoral baseline” (an aggregation of five distinct grid systems across the country). This sectoral baseline is the first gateway or level of compliance, only if this sectoral baseline is breached will the emission levels of an individual generator (known as a facility) be subject to assessment and potential restriction. This aspect of the policy will be fertile ground for discussion into the future.

Electricity generation accounts for a third of Australia’s emissions. When you consider characteristics such as an emission intensive fleet of coal fired generators that are long in the tooth (approximately 75% of the fleet is beyond their technical design life<sup>1</sup>), a chronic oversupply of generation (that contributes to subdued wholesale prices), barriers to exit for existing plants, no explicit pricing on CO<sub>2</sub> emissions and resultant challenging conditions for investment in large scale renewables, you arrive at the very real conclusion that further policy developments to address this may be required. Whether well considered regulation has a role to play or the Safeguard Mechanism could be the appropriate conduit for such change is a very live discussion point in Australian policy.

At present, it is the ERF that provides the most realistic opportunity for the emission reduction sector. According to government documentation, the ERF and Safeguard Mechanism combined will contribute approximately 350 million tCO<sub>2</sub>e to the

## THE ONLY WAY FOR EMISSION REDUCTION OPPORTUNITIES TO GO IS UP

cumulative emission reduction task.<sup>2</sup> Other key areas include energy and vehicle efficiency, technology improvements and other abatement mechanisms projected to make up the balance.

Viewed through what we know, current policy indicates the Safeguard Mechanism will not, in the foreseeable future, be designed to curtail emissions from large emitting facilities, but rather ensure they do not grow materially. One must therefore assume much of this abatement will be derived from the ERF.

This is where it is timely to return to the more positive and upbeat perspective. There are a number of sectors and experts who have expressed a lack of confidence in the ability of the ERF to deliver the reductions required. But, from a future perspective, if we assume this is correct then the current situation constitutes the minimum or floor on the opportunity for carbon abatement. Put another way, the only way for emission reduction opportunities to go is up. From the perspective of those whose business benefits from, or is designed to facilitate emission reduction opportunities, the opportunities are there at present and will only increase. This is cause for optimism into the future.

The next few months will be crucial for the sector. The finalisation of the Safeguard Mechanism will provide the guiding parameters for large emitters, giving more certainty as to the level and extent of plans required to manage their footprint, and further clarity on any opportunity for the monetisation of abatement opportunities, which lends itself to business development and further commercialisation. It will also assist in providing an environment within

which secondary and trading markets for abatement have a better chance to develop and mature.

Critically, in early November 2015, the government will hold the second of the ERF’s periodic auctions. The first auction, in March 2015, procured a projected 47 million tCO<sub>2</sub>e of emissions reductions at a reported average price of A\$13.95 (US\$9.66). This demonstrated that there exists the supply, demand and appetite for abatement, and that the price per tonne (assuming it remains within the range of the first auction) is at a level that should enable projects to make a viable business case.

While the positive attitude referred to is both encouraging and refreshing, it cannot be allowed to mask the challenges at hand. Over the last decade, climate policy in Australia has been erratic, politicised and less than conducive to long-term planning. The emerging shoots of bipartisan agreement (to the extent possible) on the need to act, an increasing consensus on the challenge at hand (if not the mechanism to meet it) and very public statements of support for action by both civil society and corporate Australia only serve to reinforce the rationale for positivity.

**Cameron Reid** is Manager, Carbon & Renewable Policy at AGL. He is responsible for influencing, understanding and communicating the impact (short and long term) of climate change, carbon policy and renewable energy policy on AGL operations. Most recently, Cameron was heavily involved in the development of AGL’s revised Greenhouse Gas Policy and public commitments which saw the organisation commit to decarbonisation of its generation fleet by 2050.



(1) Nelson, T., Reid, C. and McNeill, J. (2014), “Energy-only markets and renewable energy targets – complementary policy or policy collision?” (2) Australia’s 2030 Emissions Reduction Target, via the Department of Environment website

## BUILDING A KOREAN ETS FOR THE FUTURE

At the start of 2015, the world's second-largest national emissions trading system began in South Korea. Sungwoo Kim and Hyoungchan Kim evaluate its performance so far and the outlook for the post-2020 Korean carbon market

The Korea Emissions Trading Scheme (KETS) began at the start of 2015, with the aim of achieving the government's 2020 reduction target of a 30% cut compared with business as usual, in a cost effective manner. In terms of emissions covered, the KETS is the second largest market after the EU ETS, and it is expected to play a leading role in spreading emissions trading to developing and emerging countries.

The 525 covered entities consist of private companies and public organisations with emissions greater than or equal to 125,000 tCO<sub>2</sub>e at the entity level, or greater than or equal to 25,000 tCO<sub>2</sub>e at an installation level. In total, 66% of national GHG emissions are captured by the programme.

The first two compliance periods both span three years (2015-17 and 2018-20), expanding to five years from Phase III (2021-25). Emitters are obliged to submit allowances corresponding to their emissions by the end of June of the subsequent calendar year, with penalties for noncompliance, set at around three times the average trading price of the compliance year by the Ministry of Environment, up to a maximum of KRW 100,000 (approximately \$90) per tCO<sub>2</sub>e.

### PHASE I SO FAR...

The total allowances issued for Phase I represent 1,687 million t CO<sub>2</sub>e. Of these, 95% has been allocated, and the remaining 5% is reserved for unexpected new installations and capacity expansions, for early action, and for market stabilisation measures.

The total volume of allowance traded in the KETS's first nine months amounts to a reported 181,380 tonnes. By comparison,

in the past, approximately 780,000 tonnes of offset credits during the same period, focusing on reduction results via Clean Development Mechanism (CDM) projects, were traded with a total trade value of \$8 million. It has been reported that, as of October 2015, 19 transactions have happened in the market so far. Even though the system is still at its preliminary stage so it is too early to judge its effectiveness, for an active and smoothly operating market system, it is worth taking note of the concerns below.

Two main factors appear to be limiting further active trading: the unlimited banking of allowances, and the dominance of a relatively small number of players in the market - 50 companies account for 80% of allocations. It is also difficult for many covered entities to access CDM credits which had been expected to be used to cover much of the shortfall - participation in 70% of domestic CDM projects was limited to a handful of covered entities.

The carbon price therefore seems to reflect the intent of the government that allowance prices should remain around KRW10,000 for market stability, rather than the economics of abatement, and this may result in weakening the incentive for emission reductions for participating entities.

Given that most participants are expected to have a shortfall of allowances, lack of

liquidity in the market is a more immediate concern than price volatility, especially given the limited range of realistic abatement options, at least in the short term. This led many players to stockpile offsets before the launch of the KETS and carry the costs of these forward on their balance sheets against future shortages of emission allowances.

### LESSONS LEARNT

As recommended by the IPCC, most developing countries set emissions reduction targets against business-as-usual (BAU) projections. Our experiences with the KETS demonstrate the importance of considering uncertainty in setting a cap with BAU projections.

Unlike developed countries, it is critical to disclose information on how future emission scenarios are determined, and whether the involvement of stakeholders is guaranteed in the processes of cap setting, to ensure emissions reductions and economic growth are achieved.

The market mechanism should function properly: it should send a price signal based on market activity so that emitters can establish cost-effective reduction strategies. When the number of participants in the market is limited, and a few entities hold a significant number of allowances, it is fundamental to consider how to increase the liquidity of emission trading. A possible solution is to offer an opportunity for other players to participate in the market, and

## THE KETS DEMONSTRATES THE IMPORTANCE OF CONSIDERING UNCERTAINTY IN SETTING A CAP WITH BUSINESS-AS-USUAL PROJECTIONS

encourage the trade of derivative products facilitating the market but not interfering with market stability.

## TO PARIS – AND BEYOND

The Korean government submitted its Intended Nationally Determined Contribution for the Paris agreement to the UNFCCC at the end of June. It essentially states that the country's voluntary commitment is to reduce GHG emissions by 37%, compared to BAU projections, by 2030. Of the required reductions, 11.3% will be met with international credits, and the reduction target for the industrial sector will not exceed 12%. When the national emissions reduction target is set via the conclusion of the UNFCCC 21st Conference of the Parties (COP 21) in Paris, the government will provide a detailed implementation plan, including the annual reduction targets for each sectors.

## IT IS CRITICAL TO DISCLOSE INFORMATION ON HOW FUTURE EMISSION SCENARIOS ARE DETERMINED

Some experts have highlighted that the 2030 domestic reduction target (26%, after deducting the international carbon credits from the total reduction target), is lower than the existing target for 2020 (30%), and moreover, the reduction target for the industrial sector eases from 18.5% to 12%. This is mainly because the changes could allow KETS entities to expect an adjustment of the reduction target for 2020 and, most importantly, additional allocation during Phase I. It may lead to an increase of market uncertainty, and consequently, make the entities to delay their own decision makings for further investment to mitigate their carbon emissions during the first compliance period. Thus, it is highly recommended to minimise market uncertainty by finalising the mitigation roadmap 2030 as early as possible.

**Sungwoo Kim** is the Regional Head of Climate Change & Sustainability in KPMG Asia Pacific, with over 16 years of professional experience. He has been advising public and private decision-makers since 2008 on issues related to carbon pricing, climate finance, and corporate social responsibility. He is a member of World Bank External Advisory Group for sustainable development.

**Hyoungchan Kim** is a Director in KPMG Korea, and has over 10 years of professional experience in climate change and sustainability practices. He advises Korea Government on development and implementation of ETS, and private sector clients on its low carbon strategy and carbon market engagement.

