

Exposure Draft Amendments:  
Safeguard Mechanism Rule  
Consultation  
**submission**

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## Executive Summary

**The Carbon Market Institute operates at the interface of climate change policy and business in Australia. Independent and non-partisan, we're the peak industry body for climate change and business and we are dedicated to helping business seize opportunities in evolving carbon markets. We believe that market-based approaches are the most efficient policy mechanisms to address the challenge of climate change.**

Under the first compliance year of the Safeguard Mechanism, there was successful trading in emissions, which augers well for the time when Safeguard Mechanism baselines inevitably decline to meet below business as usual emissions reductions required to meet Australia's Paris Agreement commitments.

Data released by the Clean Energy Regulator (CER) indicated that under the first year of the Government's Emissions Reduction Fund (ERF) Safeguard Mechanism sixteen facilities exceeded emissions limits, collectively surrendering 448,097 Australian Carbon Credit Units (ACCUs) to meet compliance obligations. Companies that had a liability under the Safeguard Mechanism were able to utilise ACCUs from their own ERF projects or purchase ACCUs directly on the secondary market, where project developers were able to meet supply.

The Safeguard Mechanism in its current form was not expected to result in a liability for covered entities. To provide clarity for business to manage future liabilities under the Safeguard Mechanism, it is now more important than ever that the Government define the conditions and criteria on how facility baselines will decline to align with the trajectory of our Nationally Determined Contributions (NDC) under the Paris Agreement.

**Two other key questions now come into focus: how will the market evolve and how will domestic supply meet demand?**

In making any changes to the Safeguard Mechanism it will be crucial for the Government and the private sector to work together, to ensure domestic offset supply can meet the demand driven by compliance under this primary policy instrument. This will require the development of new abatement methods, more R&D, innovative financing, and clarity about how international markets will be linked.

When Australia became a Signatory to the Paris Agreement, a National Interest Analysis by the Department of Foreign Affairs and Trade (DFAT) identified that Australia has a clear national interest in ratifying the Agreement, and that ratification will confirm our commitment to fulfil our 2030 emissions reduction target. The Paris Agreement signals a transition to a low emissions economy and it's in the best interest of Australia's economic future to ensure our climate policies, particularly the Safeguard Mechanism, evolve to achieve our targets and commitments.

Providing clarity on how current policies will evolve to align with our national targets and affect real, long-term emissions reductions is imperative. Enhancing the Safeguard Mechanism and strengthening its contribution towards achieving Australia's emissions reduction objectives should therefore be the priority for Government between now and 2020.

Our response to the exposure draft is therefore focused on the pathways and policy imperatives that can invigorate climate policy progress across Australia's economy, including how the current policy architecture under the Safeguard Mechanism can be used to meet Australia's international commitments. Improving the operation and design of the Safeguard Mechanism, along with complementary strategies and policies, can bring about a meaningful and lasting contribution to the emissions reduction challenge that Australia has committed to as a signatory to the Paris Agreement.



## Summary of Policy Options, Considerations & Recommendations

1. The Government should update and **redefine the objective of the Safeguard Mechanism** to ensure that it makes an effective and significant contribution to the absolute emissions reductions needed for Australia to achieve its commitments under the Paris Agreement.
2. The Government should determine **the specific quantum and/or percentage contribution that the Safeguard Mechanism will make in meeting Australia's existing emissions reduction targets** and how that will vary under future enhanced UNFCCC commitments.
3. A **stable, enduring policy environment** is needed in Australia as the importance of **managing climate change risk** is increasingly important for Australia's competitiveness in the global economy.
4. The Safeguard Mechanism should **transition to a scalable, multi-sector market mechanism** that leads to an absolute emissions reduction across the economy.
5. The Government should **increase coverage of the Safeguard Mechanism by lowering the threshold to 25,000 tCO<sub>2</sub>-e** to allow a greater proportion of the economy to contribute to Australia's emission reduction targets.
6. It is important that **all facility baselines are up-to-date and reflective of current operations** and existing 'headroom' is removed before the trajectory of the Safeguard Mechanism baselines are set to drive emissions reductions.
7. The Government should provide clarity on the conditions, criteria and process for **how emissions baselines under the Safeguard Mechanism will be adjusted to decline** in the post-2020 period.
8. To inform future compliance costs under the Safeguard Mechanism, the Government should research and model the **factors affecting availability, future supply and demand, and price for domestic and international units**.
9. The Government should ensure the **enhancement and scaling up of the domestic offset market** to ensure entities covered by the Safeguard Mechanism have **access to a liquid market for credits to meet compliance obligations at least cost**.
10. To reduce market uncertainty and support participants in Australia's carbon market, the Government should **increase transparency on future demand for ACCUs** under the Safeguard Mechanism.



## Background

The Australian Government Department of the Environment and Energy (the 'Government') released the exposure draft amendments to the *National Greenhouse and Energy Reporting (Safeguard Mechanism) Rule 2015* (the 'exposure draft') in July 2018 for public comment. These amendments draw on the Government's consultation process undertaken in March 2018 which focussed largely on the design aspects under the Safeguard Mechanism – a key element of the Emissions Reduction Fund (ERF) – for individual facility baselines and how the process for setting baselines can be made 'fairer and simpler', whilst also reducing compliance costs and ensuring baselines reflect the current operating environment for businesses.

In line with the feedback received from the March 2018 consultation process, the proposed policy changes under the exposure draft relate to the following:

- Bringing baselines up to date and allowing all facilities access to calculated baselines.
- Simplifying applications for calculated baselines by allowing the option to use prescribed production variables and default emissions intensity values, to be determined by the Government.
- Allowing baselines to be updated annually based on actual production where facilities use eligible production variables.

The CMI acknowledges that these design aspects in the exposure draft provide flexibility for facilities covered by the Safeguard Mechanism (in particular between now and 30 June 2020 when reported baselines expire). However, they do not provide any indication of how this policy instrument will contribute to a reduction in absolute emissions over the long-term. As facilities covered by the Safeguard Mechanism begin to transition to production-adjusted baselines, we will begin to see fluctuations in absolute emissions with baselines tied to a facility's production. The proposed amendments in the exposure draft represent a short-term focus on the design aspects of the legislation but do not address the broader industry and business concerns regarding the role of the Safeguard Mechanism in achieving Australia's long-term emissions reduction commitment made under the Paris Agreement.

## Australia's Paris Commitments

In August 2015 Australia submitted its Nationally Determined Contribution (NDC) under the Paris Agreement. Our NDC clearly states that Australia will "**implement an economy-wide target to reduce greenhouse gas emissions by 26 to 28 per cent below 2005 levels by 2030**".

When Australia became a Signatory to the Paris Agreement, a National Interest Analysis by the Department for Foreign Affairs and Trade (DFAT) identified that Australia has a clear national interest in ratifying the Agreement, and that ratification will confirm our commitment to fulfil our 2030 emissions reduction target. The Paris Agreement signals a transition to a low emissions economy and it's in the interest of Australia's economic future to ensure our climate policies, particularly the Safeguard Mechanism, evolve to achieve our targets and commitments.

Globally there continues to be a trend towards long-term net-zero emissions reduction targets with countries and regions setting ambitious targets out to 2050. Similarly, organisations are redefining their strategies to address climate change risk and are progressively setting internal emissions reduction targets and carbon prices to manage future liability. Market-based mechanisms are increasingly being recognised as an effective way to achieve these targets.



Given the ERF and its Safeguard Mechanism remain the primary legislated climate policies in the Government's list of Direct Action approaches put forward to meet our 2030 emissions reduction target as committed in our NDC, **there needs to be a clear indication of how facility baselines are intended to decline.** In Australia we have seen the emergence of a functioning carbon market during the first compliance period under the Safeguard Mechanism, and reasonably expect this to continue into the second and subsequent compliance years.

## The linkage of the Safeguard Mechanism with other policies

Australia's climate and energy policies need to be linked. The importance of managing climate change risk is increasingly important for Australia's competitiveness in the global economy, and a stable, enduring policy environment is needed in Australia in order to provide market certainty and make a significant contribution to reducing absolute emissions in line with our international commitments.

Safeguard facility reported emissions data for the first year of the Safeguard Mechanism's operation to 30 June 2017, indicated that of the 203 facilities covered by the Government's Safeguard Mechanism in the 2016-17 reporting year, sixteen facilities emitted higher CO<sub>2</sub>-e levels than permitted by their legislated baselines. These facilities engaged in carbon market activity to purchase and surrender ACCUs to acquit their respective liabilities by the 28 February 2018 deadline.

Recent policy developments in the Australian energy sector with the Government's proposed plan for a National Energy Guarantee (NEG) indicated that there was potential for the use of ACCUs under the emissions guarantee component in the original design. Despite the uncertainty surrounding future energy policy in Australia, other global developments such as the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) continue to point to the fact that the evolution of carbon markets and demand for carbon offsets is increasing and will drive market demand.

It is now critical that the framework for how the Safeguard Mechanism evolves is clarified, including how it links with the domestic supply of credits from the ERF, how we link with international markets, and how it interacts with emerging energy policy developments. Delaying action and decisions in relation to Australia's climate policy suite will only further disrupt our economy in the long-term, as the impacts of climate change render the low carbon transition more challenging and costly.

In Australia's 2017 Climate Policy Review, the Government committed to start developing in 2018 a long-term emissions reduction strategy by 2020 that will explore emissions reduction opportunities and implications across all major sectors of the economy. The Government also stated that this review by 2020 will consider the role of the Safeguard Mechanism in the context of Australia's commitments under the Paris Agreement.

Providing clarity on how current policies will evolve to align with our national targets and affect real, long-term emissions reductions is imperative. Enhancing the Safeguard Mechanism and strengthening its contribution towards achieving Australia's emissions reduction objectives should therefore be the priority for Government between now and 2020.



## Guiding Principles

In developing this response, the CMI has been guided by a series of principles. These are:

- Australia's national emissions reduction target should be in line with the global response to the threat of climate change to keep temperature rise this century **well below 2 degrees Celsius** above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5 degrees Celsius. The Government should confirm a long-term goal of an economy wide zero-net emissions target.
- The Carbon Market Institute views a **market-based approach** to emissions reduction as providing an effective, efficient framework to meet emissions reduction goals and challenges at lowest cost. The primary policy instrument to reduce emissions across the economy should involve emissions trading and putting a **price on carbon**.
- Australia's policy suite should be **comprehensive and enduring** to create a stable and predictable policy landscape for business; climate policies should be reviewed at predetermined intervals again in line with commitments made under the United Nations Framework Convention on Climate Change (UNFCCC) and evolving market conditions.
- Policies designed to reduce emissions from large emitters (including the energy sector) should be **aligned with the trajectory** required to meet current and future targets which are likely to be set at more ambitious levels leading to a net zero emissions economy. To meet emissions reduction targets at lowest cost to the economy, Australia should open opportunities to link and trade with international markets.

The Government should ensure that the Emissions Reduction Fund (ERF) and its Safeguard Mechanism (as the Government's stated primary mechanisms to reduce emissions) have the flexibility to evolve and engender bipartisan support. This will be central to alleviating uncertainty; obviating the need to overhaul or repeal existing policy; and ensuring an effective, stable and enduring policy environment.

**It is under the above paradigms that CMI has formulated the following response to the exposure draft amendments proposed under the Safeguard Mechanism Rule.**



## Policy Options, Considerations & Recommendations

### 1. **The Government should update and redefine the objective of the Safeguard Mechanism to ensure that it makes an effective and significant contribution to the absolute emissions reductions needed for Australia to achieve its commitments under the Paris Agreement.**

When the Safeguard Mechanism was first established, it was described as being “designed to ensure emissions reductions purchased by the Government are not offset by significant increases in emissions above business as usual levels elsewhere in the economy”. At that time, the ERF Auctions were the primary driver of abatement in Australia. However, with no additional funding committed by the Government, the ERF alone will not continue to drive abatement in the long-term. In an environment where Australia has committed to achieving emissions reductions below business as usual – and the Safeguard Mechanism is a critical policy to drive below business as usual emissions – the objective of the Safeguard Mechanism should therefore be redefined.

It is clear that under a business as usual scenario, the Government’s existing climate policy suite does not effectively constrain or reduce emissions in a way that will enable Australia to meet its 2030 targets. The Government’s own Safeguard Mechanism is capable of limiting and reducing emissions without legislative change (through the adjustment of baselines) and should be the primary policy to do the heavy lifting to drive down absolute emissions to 2030 and beyond.

Australia’s target under the Paris Agreement should be a starting point for policy decisions regarding the evolution of the Safeguard Mechanism. Our international obligations are likely to become more stringent over time with the five-yearly pledge-and-review system of the Paris Agreement. It should be noted that as the cumulative task increases in line with our Paris Agreement commitment to strengthen emission reductions over time, the total reductions under the Safeguard Mechanism will also have to increase.

The Safeguard Mechanism objective needs to be updated and redefined as the primary market-based measure which makes an effective contribution to drive below business as usual emission reductions over covered entities to achieve our international targets. With the prospect of the Safeguard Mechanism effectively capping emissions it increases the likelihood of bipartisan support, enabling the policy to withstand multiple election cycles and provide the much-needed long-term certainty to business and investors across the economy.

### 2. **The Government should determine the specific quantum and/or percentage contribution that the Safeguard Mechanism will make in meeting Australia’s existing emissions reduction targets and how that will vary under future enhanced UNFCCC commitments.**

The indicative contribution of the Safeguard Mechanism to the cumulative 2030 emissions reduction task outlined in the Prime Minister and Cabinet’s UNFCCC Taskforce report<sup>1</sup> is the largest of all emission reduction sources outlined by the Government. This implies the Safeguard Mechanism will play a significant role in reducing Australia’s emissions, especially in the post-2020 period.

In its current form, the Safeguard Mechanism is unlikely to make a significant contribution, if at all, to reducing emissions below business as usual levels as the baselines are not set to drive the significant emission reductions required to meet our 2030 target. The Government should therefore determine the

<sup>1</sup> Commonwealth of Australia, Department of the Prime Minister and Cabinet, Setting Australia’s post-2020 target for reducing greenhouse gas emissions. Final report of the UNFCCC Taskforce.



contribution in terms of the quantum and/or percentage of emissions reduction the Safeguard Mechanism is to make to Australia's targets and implement policy changes that will facilitate the adjustment of baselines accordingly.

Any market mechanism that is to be enduring needs to be flexible to accommodate changing emission reduction circumstances and increased international obligations. Aligning the trajectory of Safeguard Mechanism baselines with international targets is central to allowing our current and future commitments to be met. This will provide additional clarity on future compliance obligations for covered facilities, a clear market signal and a more stable and predictable landscape for business.

**3. A stable, enduring policy environment that links climate and energy policy is needed in Australia as the importance of managing climate change risk is increasingly important for Australia's competitiveness in the global economy.**

Since the recommendations of the industry-led Taskforce on Climate-Related Financial Disclosures (TCFD) were released, the business community and investors have placed increasing importance on managing climate related risks. Established by the Financial Stability Board (FSB), the TCFD recommendations have provided a consistent framework for companies to disclose their climate-related financial risks. The TCFD climate disclosure model has been widely supported by Australia's largest entities, and many have already disclosed scenario analyses in their company publications in line with the TCFD recommendations.

It is therefore critical that Australia's energy and climate policy frameworks are aligned to address Australia's international emissions reduction commitments and provide a more stable and predictable landscape for business. How the Safeguard Mechanism evolves and interacts with policy developments in the energy sector is an important consideration for the Government to drive decarbonisation of the energy sector and more broadly. Presently, it is not clear how the Safeguard Mechanism and any future energy policy (e.g. the Energy Security Board's proposed National Energy Guarantee) will interact. In an environment where the global energy system is transforming, effective policy decisions can act as an enabler for an economically secure energy future.

Australia's policy environment should provide long-term certainty to business and investors across the economy. The boards of Australia's largest companies are increasingly recognising that addressing the potential financial impacts of climate change is key to managing material business risks.

**4. The Safeguard Mechanism should transition to a scalable, multi-sector market mechanism that leads to an absolute emissions reduction across the economy.**

Increasingly, market-based mechanisms are being recognised and adopted in many international jurisdictions as an effective and low-cost option for achieving emissions reductions. The Climate Change Authority's (CCA) 2016 Climate Policy Toolkit<sup>2</sup> concluded that a well-designed market-based mechanism that is flexible and scalable can meet Australia's emissions reduction obligations, whilst also being environmentally effective and equitable.

In its existing form, the Safeguard Mechanism demonstrated that Australia already has a framework within which a successful carbon market can operate. Responsible emitters in the first compliance year of the Safeguard Mechanism with a facility who exceeded its baseline had a liability, and as a result were actively trading in the domestic offset market to purchase and acquit ACCUs and make good on their

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<sup>2</sup> Towards a Climate Policy Toolkit: Special Review on Australia's Climate Goals and Policies, Australia Government Climate Change Authority, August 2016.



emissions exceedance. They were able to purchase ACCUs directly from project developers on the secondary market, and the market was able to meet supply. If the Safeguard Mechanism is already a legislated form of emissions trading, then it can evolve in a way that is consistent with the existing architecture and baseline setting process.

As facilities covered under the Safeguard Mechanism begin to adopt production-adjusted baselines that are based on emissions intensity, the effectiveness of this market mechanism will be dependent on the coverage of the scheme; the level at which the emissions intensity baselines are set; and the framework under which baselines are adjusted over time. The conditions, criteria and process for baseline adjustments is discussed further in section 7.

Assigning baselines to entities that are based on emissions intensity can create incentives for businesses to explore lower emissions production pathways and, when coupled with a defined rate of decline for the emissions intensity baseline (and other flexible compliance options such as the use of domestic and international offsets), can drive the transition to a low emissions economy. A clear price signal is required to drive private sector investment in emissions reductions and a well-designed market mechanism can provide this signal whilst removing potential volatility in the transition to a net-zero economy. See further discussion on the supply and use of offsets in sections 8 and 9.

Emissions reduction policy and the transition to a net-zero emissions economy will impact different sectors and industries in different ways. How individual sectors can most effectively contribute to Australia's emissions reduction target under the Safeguard Mechanism to ensure a just transition across the economy needs to be defined.

Heavy emitting sectors captured by the Safeguard Mechanism are vulnerable to competitiveness issues. Under a scalable, multi-sector market mechanism it will be important to consider how key trade exposed industries in Australia can remain competitive. Allowing the use of domestic offsets and eligible international permits as flexible compliance options can ease the burden for covered entities liable under the Safeguard Mechanism, whilst also assisting Australia to maintain its comparative advantage in emissions intensive industries and contribute to international emissions reduction efforts. This is providing there is adequate supply of offsets at a price that is not prohibitive.

Australia's treatment of Emissions Intensive Trade Exposed (EITE) industries should be informed by developments in global markets, where carbon pricing policies and broad-sector emissions trading schemes continue to rapidly evolve. The EU and California have set clear objectives in their policies for the level of transitional assistance received by the industrial sectors and importantly, how this assistance will decline over time. Australia's policy framework must recognise that an efficient and effective transition is required to meet Australia's long-term emissions reduction targets.

Under the Energy Security Board's proposed National Energy Guarantee (NEG), the electricity sector was originally subject to an emissions guarantee. It was not clear however how the Safeguard Mechanism was to interact with the proposed NEG and what that meant for the coverage of emissions from the electricity sector. The CCA's 2016 Climate Policy Toolkit concluded that the "electricity sector is the most suitable to be covered by a market mechanism in the near term". In December 2016, the Government ruled out the prospect of introducing an emissions intensity scheme for the electricity sector, however the Safeguard Mechanism has the regulatory architecture in place to be adapted to drive emissions down in the electricity sector using the same market mechanism that applies to other heavy emitting sectors.

If the Safeguard Mechanism is to evolve and transition to a scalable, multi-sector market mechanism it is important to consider the optimal level at which future baselines are established and how these will be



tightened over time so that the Safeguard Mechanism makes a significant contribution to Australia's absolute emissions reduction target. Importantly, the frequency at which baselines are adjusted to account for changes in industry and production output should be defined. A recalibration of the emissions reduction trajectory for sectors covered by the Safeguard Mechanism should be aligned with the timing of the Pledge and Review mechanism under the Paris Agreement whereby NDC targets are to be reviewed every five years (commencing in 2023). This would ensure the contribution of the Safeguard Mechanism continues to remain in line with Australia's 2030 target.

Any market mechanism that is to be enduring needs to be flexible to accommodate changing emissions reduction circumstances and increased international obligations. The evolution of the Safeguard Mechanism into an effective market-based mechanism would assist in stimulating investment activity to meet emissions reduction targets, allowing them to be achieved at least cost to the economy. Crucially, caps or limits on emissions under a market-based mechanism can be adjusted to meet current and future abatement targets that lead to an absolute emissions reduction across the economy.

Ultimately, if the Safeguard Mechanism is to endure as a core component of Australia's climate policy and allowing for future refinements, a dedicated review should consider how the Safeguard Mechanism can evolve into a fully functioning market mechanism.

**5. The Government should increase coverage of the Safeguard Mechanism by lowering the threshold to 25,000 tCO<sub>2</sub>-e to allow a greater proportion of the economy to contribute to Australia's emission reduction targets.**

The Clean Energy Regulator to date has published over 400 baseline determinations for facilities exceeding the 100,000 tCO<sub>2</sub>-e threshold under the Safeguard Mechanism. These high-emitting facilities are liable under the Safeguard Mechanism however there is still a significant portion of Australia's emissions that are not covered.

The Government should consider lowering the Safeguard Mechanism threshold to 25,000 tCO<sub>2</sub>-e, which will increase both the coverage of the mechanism and its capacity to contribute to Australia's economy-wide emissions reduction targets. This would also align the Safeguard Mechanism with facility reporting obligations under the National Greenhouse & Energy Reporting (NGER) scheme and include most facilities that were covered under the former Carbon Pricing Mechanism.

Coverage should be based on modelling of the emissions abatement profile and trajectory of emission reductions required to meet our Paris Agreement commitments. Identifying the contribution that the Safeguard Mechanism is to make to the abatement task and calibrating the coverage of the Safeguard Mechanism against this task is crucial for informing how the threshold is set. Without a greater proportion of entities covered under the Safeguard Mechanism, the emissions reduction task will rely more heavily on a relatively small number of companies.

**6. It is important that all facility baselines are up-to-date and reflective of current operations and existing 'headroom' is removed before the trajectory of the Safeguard Mechanism baselines are set to drive emissions reductions.**

Reported baselines issued to liable entities at the commencement of the Safeguard Mechanism were based on a historical emissions high-point from data reported under the NGER scheme between 2009-10 and 2013-14. Approximately 75 facilities have since been able to successfully apply for a calculated baseline on the basis that the reported baseline was no longer reflective of their current operations, for various reasons. These facilities that applied for a calculated baseline therefore had the capacity to



increase the level of emissions since the commencement of the Safeguard Mechanism on 1 July 2016 relative to their previous baseline.

A further 6 facilities have received a multi-year monitoring determination, meaning they can exceed their baseline provided the annual average over a nominated period remains below the facility baseline. Whilst providing operations with flexibility, these options do little toward reducing absolute emissions across the economy.

Under the current design of the Safeguard Mechanism, entities that fall below (and in some cases well below) their reported emissions baseline are not required to apply for a calculated baseline. The Government's proposed amendments to the safeguard rule in the July 2018 exposure draft have acknowledged that the use of historical baselines will not always reflect the current operating environment for facilities and are therefore allowing all facilities to access a calculated baseline. This means facilities expecting to exceed their current emissions baselines can apply (or re-apply) to have their baseline increased, subject to the application criteria under the Rules.

For liable entities with seemingly generous baselines however, this amendment to bring baselines up-to-date does not act to remove any 'headroom' that presently exists until current baselines expire. In some cases, this won't occur until 2020 (when reported baselines expire). Transitioning all facilities to more reflective baselines to re-establish the national baseline across all covered facilities should be the immediate priority for the Government. This is an essential element for establishing a true reference point from which the declining trajectory of baselines under the Safeguard Mechanism can be set and aligned with our international emissions reduction targets.

## **7. The Government should provide clarity on the conditions, criteria and process for how emissions baselines under the Safeguard Mechanism will be adjusted to decline in the post-2020 period.**

Australia needs a predictable long-term policy environment that can evolve to meet increasingly ambitious emissions reduction targets. Achieving an emissions reduction target of 26 to 28 per cent below 2005 levels by 2030, as has been stated in Australia's NDC under the Paris Agreement, requires alignment between our climate change policy suite and our target.

The Government should consider maintaining the current policy architecture established under the Safeguard Mechanism and adapting the framework by implementing design features that will drive down emissions nationally. Providing a clear trajectory of how the baselines of Australia's largest emitters will steadily decline can provide increased certainty for businesses. The exact conditions, criteria and process that will be applied to future baseline adjustments must be well defined with a clear date for implementation and review cycle intervals so that facilities covered by the Safeguard Mechanism are able to plan accordingly.

A starting date for the declining of baselines should be set at 2020. By this time, the adoption of the proposed exposure draft amendments to the Safeguard Mechanism are likely to have been implemented and covered entities will have transitioned to an emissions baseline that is reflective of their current operations. From this point, liable entities should be subject to a fixed baseline that is set to decline following a predictable and defined trajectory, rather than production-adjusted baselines which, as the name suggests, will result in fluctuations in absolute emissions with baselines tied to a facility's production.

One option is that baselines could decline linearly over time to achieve Australia's long-term targets; this would align to the Government's commitment to make the Safeguard Mechanism 'fairer and simpler'. In



setting the linear trajectory under which baselines are to decline, it is important to consider Australia's commitments under the Paris Agreement, the contribution of the Safeguard Mechanism to Australia's long-term emissions reduction targets, and the impact of the declining trajectories on individual sectors.

Covered facilities require a clear understanding of the way future baselines will decline to inform the nature and timing of a compliance liability, and to inform operational and investment decision making. The baseline adjustment process could take place at regular predetermined intervals – potentially aligned with the five yearly pledge-and-review system under the Paris Agreement – thereby providing a lead time that allows covered facilities to plan accordingly.

It is critical that the Government defines the conditions, criteria and process that will be applied to future baseline adjustments. This will be necessary to provide the assumptions and inputs required for business to undertake their own modelling and assessments of their potential liability and future emissions reduction obligations.

The conditions and criteria for how emissions baselines will be adjusted to decline could include determining:

- The quantum of abatement required to 2030 under agreed international obligations – the quantum of emissions abatement required will vary based on national inventory figures and the emissions reduction target set in the NDC;
- The quantum and/or percentage of emissions reductions the Safeguard Mechanism is to contribute to Australia's 2030 emission reduction targets;
- The results of our national inventory of emissions – the tracking of our national emissions is central to informing the abatement task;
- The 'fair' sectoral contribution of covered facilities – e.g. each sector to make a contribution to the abatement task relative to their proportion of emissions;
- The consideration of emerging energy policy decisions (including under the previously proposed National Energy Guarantee) regarding emissions targets for the electricity sector;
- Coverage of the Safeguard Mechanism – the threshold to be lowered to 25,000 tCO<sub>2</sub>-e;
- The contribution of the volume of abatement purchased at ERF auctions – the contracted, delivered abatement and funds available for auction will inform the actual and potential abatement achieved through the ERF;
- The use of international units and the proportion of international and domestic units eligible for compliance use;
- The expected emissions reductions achieved through complementary policies – e.g. the policies such as the Renewable Energy Target, the National Energy Productivity Plan and Vehicle emissions standards;
- Projection of future growth rates of the economy;
- Application of current and future technologies.

Under the right policy setting and with appropriate design features, the Safeguard Mechanism could evolve into a robust and enduring mechanism and become the primary means to limit emissions growth



across the Australian economy in line with emissions reduction targets set under our Paris Agreement commitments.

**8. To inform future compliance costs under the Safeguard Mechanism, the Government should research and model the factors affecting availability, future supply and demand, and price for domestic and international units.**

As has been observed in the first compliance period of the Safeguard Mechanism, an effective platform for the trading of ACCUs in the economy has been established. Facilities that exceeded their emissions baseline surrendered carbon offsets (in this case, ACCUs) to meet their compliance requirement, thereby establishing a carbon marketplace. This was able to occur under the legislated Safeguard Mechanism rules.

The Clean Energy Regulator confirmed that there were 448,097 ACCUs surrendered in the 2016-17 compliance year under the Safeguard Mechanism. Amendments to the safeguard rule as indicated in the July 2018 exposure draft are not expected to come into effect before the 2018-19 compliance year, therefore we can reasonably expect a continued demand for domestic offsets in the current 2017-18 period that is comparable to the number of ACCUs surrendered in 2016-17.

The CCA's 2016 Climate Policy Toolkit acknowledges that the Safeguard Mechanism is unlikely to be the most cost-effective option for reducing emissions in the long term without allowing entities to meet their obligations using domestic offsets and international credits. Access to low cost, quality abatement will therefore become increasingly important as Australia's emissions reduction task grows. Australia will also increasingly compete with demand for international abatement from other countries to meet their NDCs and commitments under the International Civil Aviation Organization's (ICAO) CORSIA.

There is a common perception in Australia that cheap international units will be around forever. The future availability and price of international units is however, uncertain, and there is unlikely to be an endless supply of cheap international units in a post-2020 environment. The availability and price of international units will be very different from the current market availability and price, which in many international markets, is already close to double the price of abatement under the ERF Auctions<sup>3</sup>.

Undertaking research to model the future supply and demand of domestic and international abatement under different scenarios is therefore imperative to support and inform policy decisions around the use and eligibility of offsets. This is an important consideration for ensuring the appropriate balance of international and domestic units for compliance under Australia's domestic emissions reduction policy and understanding the price impacts.

Any modelling to be done should include modelling of the factors that affect availability, future supply/demand, and price for domestic and international units as countries implement their Paris Agreement commitments. Although the government has signalled in its 2017 climate policy review that it has given in principle agreement for the use of international units, Australia currently does not have a policy to use these units in our compliance markets.

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<sup>3</sup> EU ETS Price – (\$AUD 28.97) at 20/08/18 (<https://www.theice.com/products/197/EUA-Futures/data?marketId=5115277>); NZ ETS Price (\$AUD 22.08) at 21/08/18 (<https://www.comtrade.co.nz/>); South Korean ETS Price (\$AUD 26.31) at 20/08/18 (<http://global.krx.co.kr/contents/GLB/05/0506/0506030102/GLB0506030102.jsp>)



The Government should determine how the balance of international and domestic units can be determined and what quantitative and qualitative restrictions are important for maintaining a domestic abatement industry and the international competitiveness of Australian business.

**9. The Government should ensure the enhancement and scaling up of the domestic offset market to ensure entities covered by the Safeguard Mechanism have access to a liquid market for credits to meet compliance obligations at least cost.**

The Government's purchasing of abatement through the ERF has played a valuable role in supporting the continuity of demand for domestic abatement, in the transition from the Carbon Farming Initiative (CFI) and the repeal of Carbon Pricing Mechanism. The ERF has catalysed the development of a suite of emissions reduction projects and preserved the highly-developed expertise in the Australian offset market across project development, monitoring, reporting and verification.

At present, the majority of national supply of ACCUs is currently contracted to the Government under the ERF however there remains uncertainty over any additional Government funding of domestic abatement under the ERF. The Safeguard Mechanism has the potential to provide a strong demand for domestic offsets through a market mechanism with a defined trajectory for declining baselines. This would provide a private market signal and transfer the cost of purchasing abatement from the taxpayer to the private sector.

The Government should consider increasing R&D funding under the ERF towards method development so that Australia can optimise investment in land sector abatement and increase supply of domestic offsets in the long term. There is an opportunity to leverage Australia's capacity to generate large-scale emission reductions from the land sector by ensuring new methods are ready and viable for landholders and ERF project developers. It is important for the Government to build on existing R&D around method development to ensure that all ERF methods provide the necessary conditions to scale up land sector abatement. Opportunities for identifying specific methods should be prioritised and potentially fast tracked, allowing for large scale development of emissions reduction projects in the land sector.

Under the Safeguard Mechanism, there will need to be an ongoing, increasing, predictable supply of offsets that can be purchased by facilities emitting above their baseline. If, as expected, Safeguard Mechanism baselines tighten over time, there will be an increased requirement for a viable supply of domestic offsets. Increasing liquidity in the secondary market is therefore critical to support increasing demand from liable entities needing to meet their compliance requirements under the Safeguard Mechanism.

It is important to note that the supply of domestic abatement will directly impact the cost of compliance under the Safeguard Mechanism. If there is a shortage of domestic units, the cost for compliance will be higher than if there is adequate supply and a liquid secondary market. Ensuring the continued development of the domestic supply of carbon credits will be a critical factor in ensuring Australia meets its emissions reduction targets at lowest cost to the economy, and will require a strong demand signal through declining baselines.

**10. To reduce market uncertainty and support participants in Australia's carbon market, the Government should increase transparency on future demand for ACCUs under the Safeguard Mechanism.**

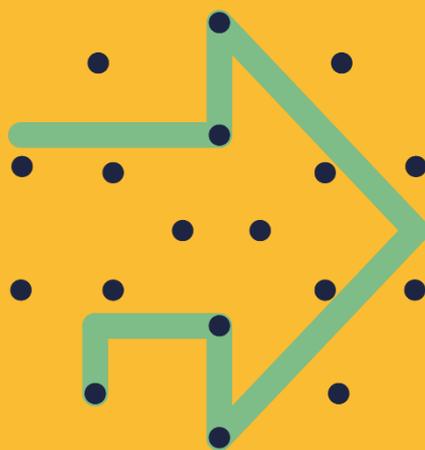
It is important that the Government discloses relevant information on carbon market dynamics to promote integrity and effective market operation. We acknowledge amendments in the exposure draft



for the disclosure of aggregated information related to the future surrender of ACCUs and support the availability of information related to future demand and supply of ACCUs for market participants.

As the role of the Safeguard Mechanism evolves over time, stakeholders require transparency on how this policy is being implemented and complied with to ensure it is delivering what it is supposed to. High levels of transparency in other schemes such as the Renewable Energy Target (RET), demonstrates what is reasonable and achievable by Government policy. Furthermore, increasing the disclosure of information related to ACCUs will improve market transparency and consequently support more informed decision making by responsible emitters as well as ERF project proponents and other stakeholders, and therefore greater market efficiency. This will further support a liquid market, and likely act to reduce overall transaction costs under the Safeguard Mechanism.

This complements our views presented in sections 8 and 9 above regarding the need to model the factors affecting availability, future supply and demand, and price for both domestic and international units, and support the growth of our domestic offset market. In order to effectively inform policy decisions, support investment and provide certainty to Australian business during the transition to a net-zero economy, an increased understanding of the future marketplace is critical for managing carbon liabilities and meet our emissions reduction targets.



## for more information please contact

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The Carbon Market Institute is at the centre of climate change policy and business in Australia. Independent and non-partisan, we bring business, policy makers and thought leaders together to drive the evolution of carbon markets towards a significant and positive impact on climate change.

Engaging leaders, shaping policy and driving action, we're helping business to seize opportunities in the transition to a low carbon economy.

