

Emissions Reduction Fund:  
Safeguard Mechanism  
Consultation Paper  
**submission**

March 2018



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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.**

The Australian Government Department of the Environment and Energy (the 'Government') has released a consultation paper on the Safeguard Mechanism; a key element of the Emissions Reduction Fund (ERF). The consultation paper is focussed largely around the design aspects 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.

Following the 2017 Review of Climate Change Policies in Australia, the Government acknowledged that there are opportunities to improve the Safeguard Mechanism and committed to consulting with the business community on what changes could be made and how these would take effect for the 2018-19 compliance year. Disappointingly, this consultation paper does not extend to addressing the broader industry concerns around the role of the Safeguard Mechanism in achieving absolute emissions reductions, how baselines will decline over time and how this policy instrument will evolve to contribute to Australia meeting its international emissions reduction commitments made under the Paris Agreement. The Government has stated that the review by 2020 will consider the role of the Safeguard Mechanism in the context of Australia's commitments under the Paris Agreement.

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"**. Of the options put forward in Australia's NDC as to how this target will be achieved, the Emissions Reduction Fund (ERF) and its Safeguard Mechanism are the primary policies that have been legislated. The Climate Policy Review conducted in 2017 did not address the key question as to how Australia's climate policies are effective in achieving Australia's 2030 target and Paris Agreement 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. Market-based mechanisms are increasingly being recognised as an effective way to achieve these targets. In Australia there has been a recent emergence of a functioning carbon market (during the 2016-17 compliance period under the Safeguard Mechanism). 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, and how we link with international markets. 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.

Progress at a national level will continue to stall if industry is not given a strong and clear message as to how the policies in place will evolve to ensure emissions decline over time to meet our emissions reduction targets. The Safeguard Mechanism has the design elements to facilitate this however the Government has not made clear the conditions, criteria and process under which facility baselines are intended to decline. Enhancing the Safeguard Mechanism and strengthening its contribution towards achieving Australia's emissions reduction objectives should be the priority for Government between now and 2020.



These priorities should include:

- Defining the objective of the Safeguard Mechanism to ensure that it makes an effective and significant contribution to Australia's long-term emissions reduction targets;
- Transitioning the Safeguard Mechanism to a scalable, multi-sector market mechanism to achieve absolute emissions reduction across the economy;
- Increasing coverage of the Safeguard Mechanism to allow a greater proportion of the economy to contribute to Australia's emissions reduction targets;
- Providing clarity on the conditions, criteria and process for how emissions baselines under the Safeguard Mechanism will be adjusted to decline;
- Ensuring the right market signals are sent to stimulate investment and growth of the domestic carbon credit market;
- Providing flexible compliance options for liable entities to meet their obligations by allowing access to international carbon offsets.

Our submission focusses 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.

## Guiding Principles

In developing this Submission, 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 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 Submission to this 2018 Review of the Safeguard Mechanism.**



## Summary of Policy Options, Considerations & Recommendations

1. For Australia to play its role in meeting global emissions reductions under the Paris Agreement, the key components of **Australia's climate policy framework should be designed to achieve long-term emissions reduction goals beyond 2030 that lead to a net-zero emissions economy by 2050.**
2. The Government should define **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.
3. 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.
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. 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.**
9. The Government should consider the **eligibility requirements for the use of international offsets under an enhanced Safeguard Mechanism** in consideration of the rules emerging under Article 6 of the Paris Agreement.
10. 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.**



**1. For Australia to play its role in meeting global emissions reductions under the Paris Agreement, the key components of Australia’s climate policy framework should be designed to achieve long-term emissions reduction goals beyond 2030 that lead to a net-zero emissions economy by 2050.**

As part of its Nationally Determined Contribution (NDC) submitted under the Paris Agreement, the Australian Government committed to an emissions reduction target of 26 to 28 per cent below 2005 levels by 2030<sup>1</sup>. As outlined in the NDC, Australia plans to meet this target through a combination of policies, including the ERF and its Safeguard Mechanism. Whilst the importance of other complementary policies is recognised, this submission is focussed on the contribution that the Safeguard Mechanism can make in achieving Australia’s targets out to 2030.

Implementation of a long-term 2050 net-zero emissions reduction target provides business with the certainty required to make necessary investments in clean energy, infrastructure and technology innovation that will reduce emissions across the domestic economy. Australia should look to long-term targets set by countries such as the United States, Canada and Germany who have all outlined ambitious long-term targets for 2050<sup>2</sup>.

Both Australia’s NDC and a 2017 climate policy review commitment to “start developing a long-term emissions reduction strategy by 2020”<sup>3</sup> highlight the importance of setting this long-term target. Knowing the end goal and timeline for achieving zero-net emissions will help frame Australia’s climate policy trajectory, and give the business community predictability and a framework for managing the low-carbon transition. Any consultation on the Safeguard Mechanism and modification of the Rules governing the policy, should be considered under the framework of the long term zero net emissions policy goal.

To support the transition to a net-zero emissions economy by 2050, the Government should define a long-term emissions reduction goal that is consistent with the UNFCCC commitments to keep temperature rise this century “well below 2 degrees Celsius above pre-industrial levels and pursue efforts to limit the temperature increase to 1.5 degrees Celsius”. Consistent with the recommendations of the Climate Change Authority (CCA) in their 2016 Climate Policy Toolkit<sup>4</sup>, a 45 to 63 per cent national emissions reduction target below 2005 levels by 2030 will provide a likely chance (67 per cent probability) of achieving the UNFCCC temperature rise goal.

In the context of Australia’s NDC, the Government needs to reduce absolute emissions in order to meet its 2030 target. It is critical that as Australia’s climate policy suite evolves, the Government implements a primary policy mechanism that places a clear limit on absolute emissions across the economy, and that this mechanism actively drives down emissions over time. With a well-designed, effective and long-term policy suite, Australia can provide a stable landscape for business decision making and navigate the low emissions transition in line with our international commitments.

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<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.

<sup>2</sup> Germany, through its Climate Protection Plan 2050 has indicated it will put in place measures to achieve a net-zero emissions economy by the half way point of the century. Both the United States and Canada have in place targets of 80 percent reductions on 2005 levels by 2050.

<sup>3</sup> 2017 Review of Climate Change Policies, Australian Government Department of the Environment and Energy, December 2017.

<sup>4</sup> Towards a Climate Policy Toolkit: Special Review on Australia’s Climate Goals and Policies, Australia Government Climate Change Authority, August 2016



## **2. The Government should define 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”. The current Safeguard Mechanism consultation paper states that “baselines are intended to accommodate business growth and allow businesses to continue normal operations”. 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 language used to describe the Safeguard Mechanism must change.

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 over time.

The Safeguard Mechanism objective needs to be 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 long-term certainty to business and investors across the economy.

## **3. 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>5</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 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 contribution in terms of the quantum and/or percentage of emissions reduction the Safeguard

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<sup>5</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.



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 potential future compliance obligations for covered facilities, a clear market signal and a more stable and predictable landscape for business.

#### **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 reduction. The CCA's 2016 Climate Policy Toolkit 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.

The Safeguard Mechanism is, in its existing form, a type of emissions trading. If covered facilities exceed their baselines they are required to make good their emissions exceedance, with the most accessible option being the purchase of emissions, in the form of Australian Carbon Credit Units (ACCUs) from the domestic offset market. This involves trading in emissions. 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.

The effectiveness of market mechanisms such as an emissions intensity or cap and trade scheme is dependent on the coverage of the scheme, the level at which the emissions intensity baselines or emissions caps are set, and the framework under which baselines or caps are adjusted over time. The conditions, criteria and process for baseline adjustments is discussed further in section 7. 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.

The Safeguard Mechanism has the framework that can evolve into an effective market mechanism that could involve setting an emissions intensity baseline for covered sectors. 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. See further discussion on the supply and use of offsets in sections 5 and 6.

If the intention through the current consultation is to transition facilities to emissions intensity baselines under an enhanced Safeguard Mechanism, this should occur by 2020. 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 is subject to an emissions guarantee. It is not clear however how the Safeguard Mechanism and the NEG will interact. 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 baseline and credit mechanism.



**5. The Government should increase coverage of the Safeguard Mechanism to 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 reductions targets.**

The Clean Energy Regulator to date has published approximately 400 baseline determinations<sup>6</sup> 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<sup>7</sup> 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.

The use of historical baselines will not always reflect the current operating environment for facilities so ensuring that baselines are reflective is a key input for developing Australia's emissions reduction trajectory. 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 proposal to bring baselines up-to-date is important as it re-establishes the national baseline across all covered facilities and removes 'headroom' that currently exists for liable entities with seemingly generous baselines. Transitioning all facilities to more reflective baselines prior to 2020 is

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<sup>6</sup> Safeguard baselines table – Clean Energy Regulator:

<http://www.cleanenergyregulator.gov.au/NGER/National%20greenhouse%20and%20energy%20reporting%20data/Safeguard-baselines-table#Summary-of-updates>

<sup>7</sup> Safeguard baselines table – Clean Energy Regulator:

<http://www.cleanenergyregulator.gov.au/NGER/National%20greenhouse%20and%20energy%20reporting%20data/Safeguard-baselines-table#Summary-of-updates>



important 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 proposed enhancements to the Safeguard Mechanism addressed in this consultation period are likely to have been implemented and covered entities will have an emissions baseline that is reflective of their current operations. From 2020, liable entities should be subject to a fixed baseline that is set to decline following a predictable and defined trajectory. In line with the Government's proposal to make the Safeguard Mechanism 'fairer and simpler', one option is that baselines could decline linearly over time to achieve Australia's long-term targets.

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. 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.

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. 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;
- 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. 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). 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.

## **9. The Government should consider the eligibility requirements for the use of international offsets under an enhanced Safeguard Mechanism in consideration of the rules emerging under Article 6 of the Paris Agreement.**

Government should examine the rules emerging under the Paris Agreement, in particular developments related to Article 6 regarding a framework for international trading in carbon, and the options for Australia to participate in international markets to achieve our emissions reduction targets. Allowing flexibility under the Safeguard Mechanism that increases compliance options for liable entities is particularly important for sectors where the decarbonisation task is more difficult due to the nature of the facility's operations.

Having access low-cost, high quality abatement from international sources (if they are available) will become increasingly important as baselines under the Safeguard Mechanism become more stringent, which will raise the need for covered entities to reduce emissions cost-effectively to maintain international competitiveness. Reducing the costs of compliance may in turn, enable the Government to raise the ambition of its emission reduction targets as Australia is expected to do under the Paris Agreement.

Article 6 of the Paris Agreement contains key market provisions that are expected to be the guiding framework for international carbon market activity and trade in emissions going forward. With the Paris Rulebook expected to be completed by December 2018, development of the text underpinning Article 6 is underway. The Government will need to be informed on the details contained within Article 6 as they emerge.

The eligibility criteria for use of international units will need to be determined before 2020 so that liable entities can access lowest cost abatement options before they experience likely scarcity and/or higher-cost abatement post-2020 (which would affect offsets as an option to manage flexible compliance and associated costs). It will be important to achieve the right balance of international abatement and



domestic abatement to ensure continuity of demand and protection of the domestic abatement sector, while ensuring abatement costs can be managed.

Having a defined set of criteria regarding the eligibility of offsets under Australia's climate policy before 2020, would support a functioning marketplace for domestic abatement and potential linkage of international markets in the future. Over 90 countries have identified the current and future possible use of carbon markets in achieving their NDCs under the Paris Agreement. The design features of Australia's domestic policy suite should aim to achieve our NDC targets and aim to align with international developments to enable the development of linkages with other markets over time.

Australia is well positioned to engage in existing and future carbon markets, and has the technology, finance and market capability to export Australian methods, technologies and expertise into partner countries, with agreement to transfer the abatement that is achieved (or part of it). Japan has a similar model – the Japanese Joint Crediting Mechanism – and has bilateral partnerships with 17 countries under this approach. The transition towards a future global carbon market under Article 6 is likely to be built on a growing network of local carbon markets, using a range of different forms of linking coupled with an overarching international architecture. As other countries are now investigating and initiating bilateral carbon market connections, it is opportune for Australia to do likewise.

Australia's ERF methods should align with and be shared across jurisdictions on a bilateral and regional basis. Sharing methods could help to advance the development of robust, comparable and potentially fungible mitigation outcomes bilaterally and in our region. Offsets from the land sector should be recognised in bilateral and regional carbon markets, as this is the likely source of Australia's supply. In its bilateral and regional discussions, it will be important for Australia and Australian business to engage proactively with the UNFCCC process, and with key potential bilateral markets to ensure that emission reductions from the land sector are recognised.

It will be important to achieve the right balance of international abatement and domestic abatement for ensuring continuity of demand and protection of the domestic abatement sector, while ensuring abatement costs can be managed. 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. Key to establishing this will be to understand the rules of trading under the Paris Agreement, as well as future supply and demand of international units under the new rules.



## **10. 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, a viable and effective platform for the trading of Australian Carbon Credit Units (ACCUs) in the economy has emerged. 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.<sup>8</sup> With no changes to the Safeguard Mechanism expected to come into effect before the 2018-19 compliance year, 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) Carbon Offsetting and Reduction Scheme for International Aviation (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.

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.

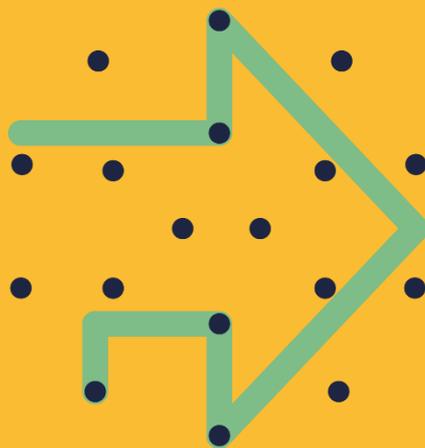
Any modelling to be done should include modelling of the factors that affect availability, future supply/demand, and price for domestic and international units as countries implement their Paris Agreement commitments. Although the government has signalled in its 2017 climate policy review that it has 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.

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.

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<sup>8</sup> 2016-17 Safeguard facility reported emissions – Clean Energy Regulator:

<http://www.cleanenergyregulator.gov.au/NGER/National%20greenhouse%20and%20energy%20reporting%20data/safeguard-facility-reported-emissions/safeguard-facility-emissions-2016-17>



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