WHO WINS IN THE END FROM FREE PERMITS?

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Emissions trading in Australia – allocation challenges

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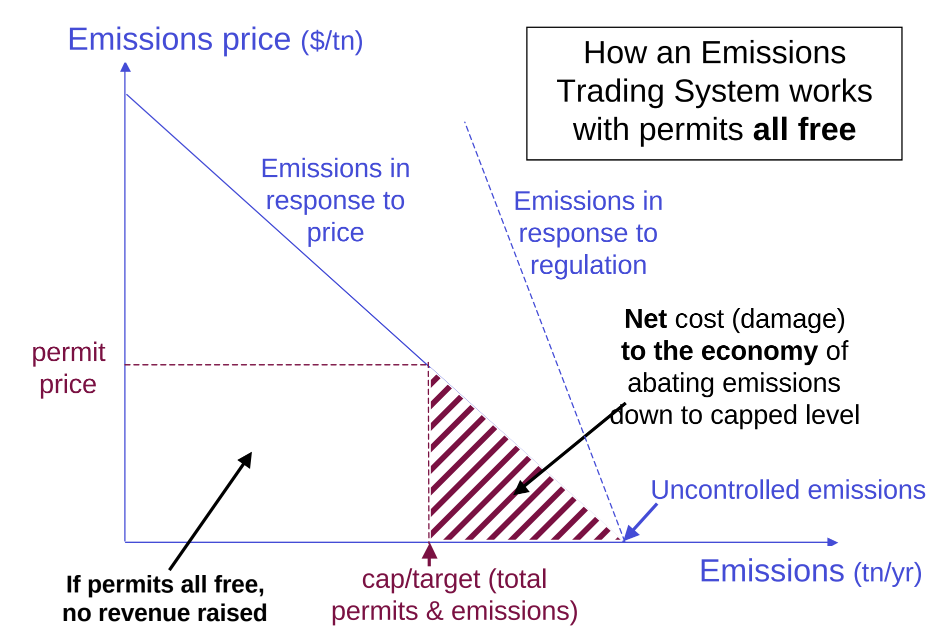


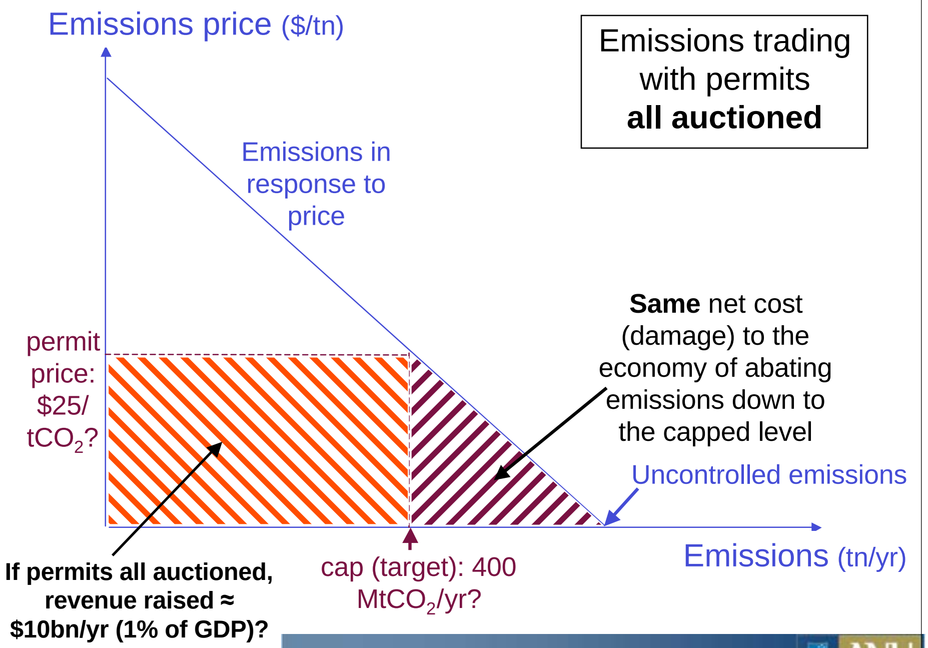
With free permits, who finally bears the net costs?

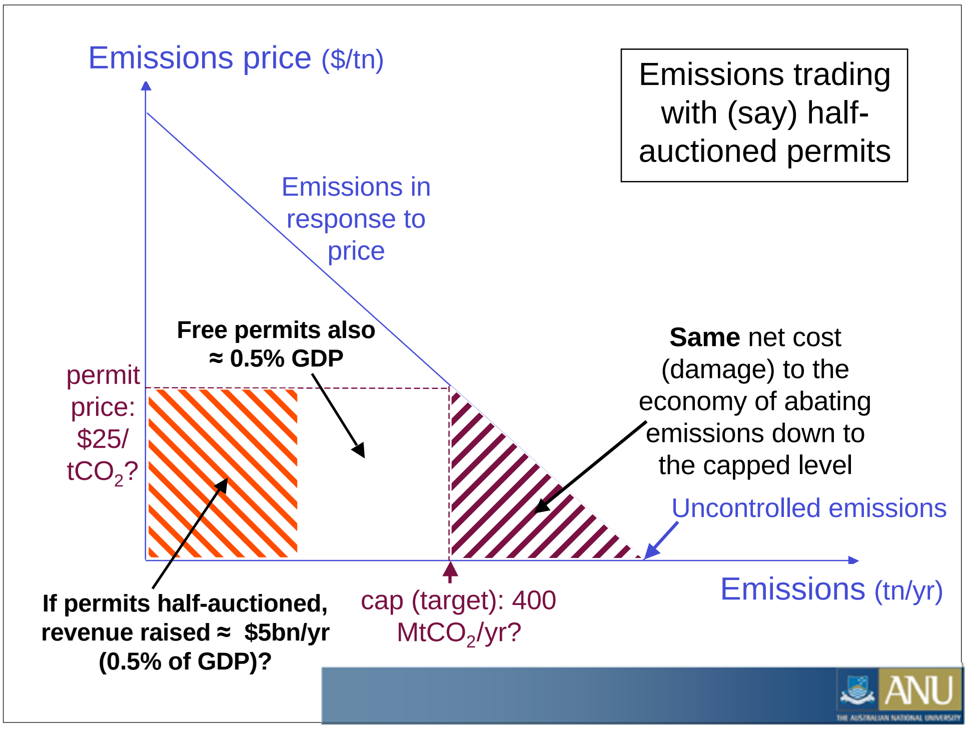
- All depends on nature of pollutant and who gets free permits
- CO_2 from coal, oil and gas-burning central to economy: not unwanted side effect like SO_2 from sulphur-burning

⟶ **carbon fuel demand inelastic** (c.f. supply): most of carbon permit price passed on to **final consumer**, as higher prices for electricity, petrol, steel, etc

⟶ net **control costs** fall mainly **not on direct emitters**

⟶ if permits **all free** to emitters, emitters make **big windfall profits**, and consumers and some workers bear bigger losses. Witness \$bn profits to electricity generators, and higher electricity prices, in Phase 1 of EU ETS.





Allocation of permits is very largely a wealth transfer

- **Free permits** should be allocated on a **once-and-for-all** basis, based on existing information. Allocating otherwise will change behaviour and undermine ETS price incentive.
  - except for emission-intensive, trade-exposed firms, EITEs, considered later.
- Who gets permits then hardly affects emissions, outputs, prices, jobs, or total costs – just people's **wealth/income**.
- "Very largely" qualification? Permits have small **wealth effect**. E.g. companies with permits may choose not to close down and sell permits, even when profitable to do so; and government spending of permit revenue may change prices/jobs a bit.

Do emitting firms deserve free permits?

- Emissions-intensive firms are big businesses, mainly owned by investment / superannuation / insurance funds. So burden of net costs of ETS will fall on:
  - thousands of actual people
  - mainly wealthy people (the wealthiest 1/5 of households own 2/3 of Australian shares
  - plenty of foreigners (they own 1/3 of listed Aus shares)
- These are the people who would win in the end from free permits to emitters — don't seem to me more deserving than others — but wealth distribution, i.e. **politics**, has to be settled somehow, even if all permits are auctioned.

Free permits needed by Emission-Intensive, Trade-Exposed (EITE) firms?

- EITE firms like aluminium, steel do need special treatment
- Trade-Exposure means firms can't increase prices to cover ETS costs, and Emissions-Intensive means this matters
- Net effect of pure ETS would be **carbon leakage**: Aussie firms shrink, their foreign competitors grow, global emissions don't fall by much (or could even grow)
- But likely effect is greatly overplayed by industry:

  "our EITE industries are in Australia for good reason and it would take a mighty lot to make them move. ... Our electricity is very cheap and even after [ETS] raises its price it may still be cheaper than in many countries... Problems...make setting up in developing countries far from a picnic." (Ross Gittins, 25 August)

More on Emission-Intensive, Trade-Exposed firms

- To ensure EITE firms given free permits don't just close down and sell their permits, free permits must be dependent on them staying in production
- But still won't have desired effect of making aluminium, steel etc dearer inside Australia, as part of cost-minimising reduction in our emissions
- Why not consider instead **border adjustments** - no free permits to EITEs, but instead subsidise exports of aluminium, steel etc (and tax imports) etc so that
- EITE firm can then do business selling at high prices inside Australia, but at world prices outside. Any conflict with WTO rules worth resolving, though devil may be in the details.

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What to do with permit auction revenue?

Has to be part of free permit debate. Many competing claims:

- **Compensation to consumers** (but not in a way that negates carbon-saving behaviour caused by carbon price)
- **Compensation to workers** made unemployed (but not in a way that negates the carbon price signal to lose that job)
- **Support low-carbon technology** and **energy efficiency** to overcome market failures for innovation and for information
- **Reduce existing taxes** like income tax, which cause deadweight losses throughout economy
- Some residual transfer to states' budgets

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What does Green Paper propose on free permits?

Emitters have to buy permits at regular auctions, **except for**

(a) Reducing the risk of 'carbon leakage' by providing some free permits to EITE industries.

30% of the declining pool of permits, of which 10% for agriculture

permits for 90% of emissions for activities > 2000 tCO_2 / \$m **revenue** (not value added),

permits for 60% of emissions for activities 1500-2000 tCO_2 / \$m

no actual measure of trade exposure

(b) An Electricity Sector Adjustment Scheme to directly assist coal-fired electricity generators during transition phase. Reason? "If change in regulation...was unanticipated and [uncompensated],...investors might regard Australian electricity market as riskier investment proposition."

What does BCA propose?

— Set a more modest overall emissions trajectory

— Provide full compensation for emissions above an emissions intensity threshold.

— Base this emissions intensity threshold on the financial impact of carbon costs.

— Set the threshold between 3-5% of industry **value-added**

— Provide compensation to all businesses that meet the emissions intensity threshold.

— Accommodate growth in the EITE industries at world's best practice in emissions efficiency

Comment on Green Paper and BCA

BCA criticism of discontinuities and revenue (not value-added) basis of Green Paper EITE plan seems justified

But avoid need for free permits by using border adjustment scheme instead, using some measure of trade exposure as well as emissions intensity. Let market determine growth of EITE, not special treatment as BCA asks.

BCA asking for more moderate overall emissions trajectory looks to be just special pleading by industry – e.g. market will determine what reduction borne by electricity

ESAS assistance to coal-fired electricity generators mainly politics, investor risk indeed unquantifiable, but whatever ESAS is, make it **once-and-for-all** assistance

THE END