The Battle for Emissions Trading Profits.

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The debate on the design of the Australian Emissions Trading Scheme (ETS) has only just begun. There have been a few opening salvos but, as yet, the battle has hardly started. The fight will be hard because the design of the ETS will make or break individual companies and maybe even entire industries. We should expect the fight to get nasty!

One of the most contentious issues is whether or not emissions intensive industries should be given free permits. This was the approach adopted when the European Union ETS was introduced in an attempt to appease industry and get the scheme approved. Europe however is now back tracking. By their nature, the emissions intensive industries are the very ones that need to change the most for any serious emissions targets to be met. If market mechanisms are implemented that exempts these companies, then an ETS cannot possibly achieve its optimum outcome.

In both his interim report published in February and the issues paper released last week Professor Ross Garnaut argues that the most efficient system will not allocate any free permits. By passing these costs through to customers, it will be the end users of industries such as coal-fired power generation, steel and aluminium who suffer price increases. This will undoubtedly influence consumer behaviour thus achieving the whole point of an emissions trading scheme - a reduction in the use of emissions intensive products and Australia's total emissions. If free permits are allocated, then consumer behaviour will not be influenced and emissions reductions will not occur as rapidly. The upside for the industries involved is that, with no change in consumer behaviour, sales will remain steady and profits will be maintained.

A system that is designed to reduce emissions must of course affect those that produce the most emissions.

The industry groups of the high emitters such as the Australian Industry Greenhouse Network have valid arguments. Why should regulations intervene in a free market? If consumers want to change to other products of better quality or lower price then that is a valid market risk. If Government intervenes, that is regulatory risk and there should be compensation for any losses.

This is an understandable position. Having operated a profitable business for many years, it feels unfair for profit to be taken away through a Government 'whim'. However, the validity of such an argument is based on the false assumption that prior profit generation guarantees the right to generate future profits. It also assumes that the current ‘free’ market is efficient and has no failures. At present the market fails by not pricing in the externality of emissions. Introducing a price on emissions just removes the unfair advantage that emissions intensive industries have held to date.

Phillip Adams in the Weekend Australian of 22/23 March compares the defensive tactics adopted by the cigarette industry when it knew it was damaging people with that of emissions intensive industries knowing they are damaging the planet. Other similarities exist. For example, the profits of cigarette companies ignore the externality of related health costs. It seems unlikely that much profit would remain if this was fully costed. The market thus fails to assign the costs associated with harm to the product causing the damage and society at large is left to carry the burden. Government intervention is required to rectify this failure. An ETS is a means by which pollution may be given an intrinsic cost and charged to companies that have had a free ride on their emissions to date.

The extent to which profits will be affected will be proportional to the extent to which individual companies have prepared for this moment. Emissions trading will not be a shock to any large company. The world has been moving towards it for many years and the well run companies will have recognised this risk and put contingency plans in place.

An argument that will be heard more as the year progresses is that there is no global benefit from Australia having more rigorous emissions standards than other countries. Trade exposed emissions intensive industries will be driven to other countries and global emissions remain unchanged whilst the Australian economy suffers. The argument for providing some compensation to prevent emissions emigration has merit given that there will be policy gaps between nations for some years. However, if Australia takes a lead in global policy, it will have a greater influence on the final global system. If implemented well, the Australian ETS will provide an example of how a good ETS system can work. Regardless of timing, there will be structural transition issues and, by undertaking early adaption to a low carbon economy, Australia can build long term competitive advantage. These long term gains will outweigh any short term economic loss, which Australia is in a strong position to bear.

The renewable energy lobby will support these views. One argument less likely to be raised by this lobby is that a favourable ETS design will reward investors and shareholders in low emissions technologies. In fact any shareholder losses from emissions intensive companies will simply be diverted to the shareholders of low emissions companies. There will be no overall loss of shareholder wealth: it will just be redistributed to those that have invested in clean technologies as opposed to those that have invested elsewhere.

The benefits that a well designed ETS will bring to the early investors in a low emissions future will act as an encouragement to all to invest in innovation that will produce a better world. This is certainly a worthy policy side effect.

The lobbying will be intense from both sides with economic rationalists in the middle trying to advocate a position of efficiency. The industry lobbies of those industries that have historically generated profits are better funded then those that are looking to generate future profits. On the low emissions side, highly emotive arguments will be made about the choice between saving the world and saving big company profits. These campaigns will not however mention the profits of the renewable energy companies that are at stake.

There is clearly a difficult balance between minimising negative economic impacts and ensuring effectiveness of emissions reduction. Garnaut genuinely appears to be trying to air views that will achieve this aim, without heeding the vested interests.

The Rudd's Government's distancing from Garnaut following his interim report was a worrying sign. Whilst it is certainly commendable to consider multiple inputs for any decision that will have such significant structural implications, it appears that the Government's position has been influenced by some views expressed by Garnaut that it did not welcome.

There should be no pretence that the introduction of an ETS will not have a dramatic impact on the Australian economy. There will be winners and losers and there is big money at stake. The aim of the scheme is to enable a transition to a low carbon economy with the least pain along the way. However, it is inevitable that there will be some local discomfort. However, the birth of the new economy will be eased by wisely spending the significant funds raised from the auction of the permits.

To provide the best outcome for Australia, and to demonstrate the most effective ETS for the world, the Government must adhere to its goal of achieving emissions targets in the most efficient way. It matters not in this context whether profits are lost by large emissions intensive industrial companies or are gained by investors in innovative low emissions companies. In addition, a long term solution requires that threats to jobs in specific sectors or regions have no impact on the policy framework. These emotive arguments must be ignored for the greatest benefit to all.

Profile of the Author

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John left Origin Energy, one of Australia's largest energy companies, after 9 years in June 2007, having spent the last 6 years working on growth, strategy and M&A projects in addition to being the founding secretary of the company's Operational Risk Committee. He specialized in reviewing and filtering clean energy opportunities and in the water industry. Through the combination and interaction of these sectors he became interested in the emerging cleantech sector and in 2004 started developing the plans for a cleantech business.

He is now running Australian CleanTech and has advised a number of organizations on their options with respect to investing in the clean energy market. He has also launched the ACT Australian Cleantech Index that tracks the performance of Australia's listed Cleantech companies, is advising State governments on policy initiatives, is managing the 'Beyond Carbon' Conference and is on the board of two currently unlisted renewable energy start-ups. He has engineering degrees from the University of Oxford and Trinity College, Dublin and an MBA from Adelaide University. He is a member of the Australian Institute of Company Directors, the Institute of Engineers Australia and the Australian Water Association.

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