Australia will have a carbon price for industry, and it may infuse greater climate action across the economy

March 30 2023, by Frank Jotzo

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Australia is about to take a big, constructive step on climate change policy: we will have a carbon price for the industry sector, under the safeguard mechanism.

It comes nine years after the Abbott Coalition government abolished Labor's carbon price. The safeguard mechanism lay as a sleeper for many years—legislated in large parts under the Coalition government, but kept ineffective due to how it was implemented.

The mechanism will become effective as a so-called "baseline and credit scheme," putting a price signal on about 30% of Australia's greenhouse gas emissions. It will create a sizeable financial incentive to cut emissions in industry, even though it also relies on land-based carbon offsets.

Under the parliamentary compromise this week between Labor, the Greens and some crossbenchers, the legislation will prescribe that overall emissions from industrial facilities covered by the scheme cannot rise over time.

Implementation of the safeguard mechanism bodes well for future climate policy in Australia. The policy does not have bipartisan support but the Dutton opposition is not vocal about it.

It could be a basis from which to expand sensible economic climate policy instruments to other parts of the Australian economy and infuse greater climate policy ambition throughout.

How the safeguard mechanism will work

The safeguard mechanism applies to 215 of Australia's largest greenhouse gas emitters. It requires them to keep their net emissions below a set limit, known as a baseline.

Facilities under the scheme include gas extraction and processing coal mines, factories producing steel, aluminum and cement, and more. Importantly, the electricity generation sector is excluded from the scheme.

The safeguard mechanism covers a smaller share of the economy than the Gillard government's carbon pricing scheme, which operated from 2012 to 2014. That scheme also covered the electricity sector and some other emissions.

But the trading price of emissions credits under the safeguard mechanism will likely be much higher than under the earlier scheme. It will be capped at A$75 a ton, with that cap rising over time.

The higher the price, the stronger the financial incentive to cut emissions, such as by investing in low-emissions processes and equipment.

Under the scheme, a facility's baseline is set depending on the emissions-intensity of the goods they produce and the amount of product they make.

New facilities will get low baselines, reflecting international best-practice in production. The federal government will issue credits to facilities that remain below their baseline emissions. If a facility exceeds its baseline, it must cover the excess by purchasing carbon credits—either from other facilities, or from outside the scheme.

The credits trade at a market price. That creates the financial incentive for everyone in the scheme to cut emissions—either to save money or to make money. In that way, it works like an emissions trading scheme.

But the scheme will not be a source of revenue for government. That has been seen as a political necessity, but it's also a lost fiscal opportunity.

A big role for offsets

Emissions baselines under the safeguards mechanism will decline by nearly 5% each year. The resulting net emissions by facilities under the scheme is estimated to decline from the current 143 million tons of carbon dioxide-equivalent to 100 million tons in 2030. It is a suitably steep reduction rate, considering industry emissions have been slowly rising.

But facilities will be allowed to emit above the declining baselines, if they offset the excess by buying Australian Carbon Credit Units (ACCUs). These carbon credits are generated by projects in agriculture, forestry and land use. The idea is that emissions reductions that cannot be achieved in industry will be achieved in the land sector and paid for by industry.

There is no limit on how many offset credits industry can use to comply with their baselines. This is unusual for carbon trading schemes internationally. It provides maximum flexibility but also makes for a vulnerability. It is possible that a sizeable share of the overall targeted emissions reductions will come from offset credits.

Australia's carbon credit system has been accused of not delivering genuine reductions in greenhouses gas emissions in some cases. For example, some offset projects might be granted credits for outcomes such as native vegetation growth that might have happened anyway.

The carbon credit scheme will be tightened following the recommendations of the Chubb review. But doubts will unavoidably remain about whether all credits represent real emissions reductions.

The revised safeguard mechanism will create new demand from industry for offset credits. This will encourage new offset projects, possibly at higher prices.

Nevertheless the ACCU mechanism invariably excludes many emissions reduction options. Additional policy efforts to cut emissions in agriculture and forestry will be needed—as well as in transport, the building sector and electricity.

The future of coal and gas

The Greens had sought a ban on new coal and gas projects in exchange for supporting the safeguard mechanism bill. So will the policy achieve this? No, though it will make the investment case harder for some fossil fuel projects.

For coal and gas production projects, the mechanism applies only to emissions that arise during the mining of coal and the extraction and processing of gas. It does not apply to the emissions produced when the fuel is burnt for energy, except when the fuel is used by another facility under the mechanism.

So the policy will create a financial disincentive for fossil fuel projects that produce a lot of emissions on site—for example, gassy coal mines and leaky gas extraction. But it does not penalize the fact that fossil fuel is produced.

So what about the amendments negotiated by the Greens—in particular, the "hard cap" on emissions? It means total emissions covered by the mechanism must, by law, fall over time, assessed over rolling five-year periods. The minister will need to be satisfied that the overall emissions objective in the legislation will be met, and may need to change the rules in future if needed.

This is a kind of safeguard on the safeguard mechanism. But it does not amount to a stop to new coal mining and gas production. It will only tend to limit new coal mines and gas fields that have high production emissions—and these face financial disincentives under the safeguards mechanism anyway.

In any case, expansion of coal and gas production is unlikely. Coal demand will decline sharply in Australia as coal power plants get replaced by wind and solar, and the international coal demand outlook is declining. No expansion of Australia's gas export industry is on the cards; the question is mostly about replacing gas fields that run out.

A question remains how to prepare for the inevitable long-term demise of fossil fuel industries, including whether Australia should in some way constrain fossil fuel production for export. The safeguard mechanism, however, is not the policy to deal with that.

Looking ahead

The safeguard mechanism will create strong incentives for large industrial emitters to cut emissions. It lays the foundations for a cleaner and more efficient industry sector in Australia.

It positions Australia for future international industrial competitiveness. It will help avoid trade penalties for imports from countries without a comparable carbon policy. It will give advantage to low-emissions production—the only kind viable in a world that acts on climate change.

The safeguard mechanism may also pave the way for carbon pricing beyond the industry sector—possibly with money flowing to government, rather than as a revenue-neutral scheme. More federal level policy effort will be needed right across the economy to complete Australia's transition to net-zero emissions.

Provided by The Conversation

Citation: Australia will have a carbon price for industry, and it may infuse greater climate action across the economy (2023, March 30) retrieved 23 June 2024 from https://phys.org/news/2023-03-australia-carbon-price-industry-infuse.html