

BENEFITS AND RISKS OF USING INTERNATIONAL UNITS

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International units can be used to help meet Australia's goals—they could reduce costs, help to address competitiveness concerns, and support broader Australian trade and foreign policy objectives. The end result can be to encourage stronger action to reduce emissions, both in Australia and overseas.

There are some risks, notably ensuring that international emissions reductions are genuine. These risks can be effectively managed by good governance and judicious access arrangements.

International emissions reductions can complement domestic efforts, in the period to 2020 and beyond. This chapter looks at the benefits and risks.

Under the Kyoto Protocol, international emissions reductions are represented by units. Each unit corresponds to one tonne of carbon dioxide equivalent (CO₂-e). To meet its Kyoto Protocol target, a country must retire a unit for every tonne of its emissions over the relevant period. Countries with targets can trade units. Units can also be generated from projects that reduce emissions in developing countries; buying countries can also use these units to meet their obligations (see Appendix A for more information on the Kyoto Protocol).

2.1 THE BENEFITS

Benefits to using international units to complement domestic emissions reductions include:

- providing access to a wider range of cost-effective emissions reduction opportunities, which lowers the overall cost of meeting Australia's targets, potentially making stronger targets more achievable.
- supporting other trade, foreign policy and development objectives
- in the long term, helping to address competitiveness concerns for industry by levelling out prices of emissions reductions across countries.

Trade can also meet other important objectives and provide benefits for sellers of units: the Clean Development Mechanism (CDM) for example, has facilitated domestic emissions reduction policies in developing countries, capacity-building for reporting and measuring emissions, and technology transfer (Stavins et al. 2014).

There is broad support for using international emissions reductions in Australia. Almost all stakeholders consulted by the Authority when preparing its Targets and Progress Review, including industry and environment groups, supported using international units to complement domestic efforts.

Many submissions in respect of the ERF also supported the use of international units, including to address competitiveness concerns, encourage a more robust global response to climate change and to lower the costs of compliance (BCA 2014; AiGroup 2014; The Climate Institute 2014; WWF Australia 2014).

2.1.1 LOWERING COSTS

Trade in emissions units can give countries and businesses access to a wider range of emissions reduction opportunities than might exist domestically. Each country has different emissions reduction opportunities with different costs. From a buyer's perspective, having access to a wider range of opportunities allows for the lowest cost options to be pursued first, regardless of where in the world they occur, reducing the cost of achieving any given target. From a seller's perspective, trade can lower the costs of choosing a less emissions-intensive development path by facilitating technology transfer and building policy expertise.

The Authority argued in its Targets and Progress Review that a mix of domestic and international emissions reductions would be a significantly cheaper option for Australia than if it used domestic reductions alone. Modelling suggested that by 2020 a domestic incentive comparable to a \$65/t carbon price could be needed to achieve the minimum 5 per cent target through domestic reductions alone.

The international market is currently oversupplied with genuine international emissions reductions which are available at historically low prices. Prices are expected to remain low in the period to 2020 (less than \$1.15 per unit). Even if global demand significantly increased, many new projects would be able to supply units at low prices (less than \$7 per unit, see Chapter 4). At these prices, international units would be cost-effective compared with many domestic opportunities.

2.1.2 TRADE AND FOREIGN POLICY OBJECTIVES

Purchases of international units can be tailored to advance other foreign policy and trade objectives. Australia could prioritise emissions reductions from neighbouring countries that are a particular focus of its development agenda or projects that use Australian technology, inputs or skills.

Such arrangements could also help foster better relationships between Australia and the countries concerned. It may be unhelpful, however, if Australia only allowed units tied to such objectives and this resulted in significantly reduced supply and increased costs.

2.1.3 LONG-TERM COMPETITIVENESS

Using international units can help to address industry competitiveness concerns by providing a cost-effective source of emissions reductions. Depending on policy design, trade in emissions reductions could also help to level out the prices of (or incentive for) emissions reductions across countries. If a business has access to international emissions reductions to meet obligations established under a domestic policy, it would pay the international price for emissions reductions, rather than possibly higher costs imposed by the policy.

Removing or reducing competitiveness concerns can make it easier to set stronger emissions reduction goals.

2.2 THE RISKS

Using international units to help meet Australia's target entails some risks, including:

- purchasing non-genuine emissions reductions
- market fraud
- delaying the transition to a low-emissions economy through desirable domestic structural adjustment

The Authority believes these risks can be managed; some strategies to this end are discussed below.

2.2.1 ENVIRONMENTAL INTEGRITY

It is important that international emissions reductions are genuine and are backed by real emissions reductions. Appropriate measurement, reporting and verification arrangements are essential to ensure the environmental integrity of units.

The focus here is on international units that count towards Australia's target under the Kyoto Protocol framework. The Kyoto Protocol has a robust system of compliance where each unit is underpinned by comprehensive emissions reporting arrangements that are subject to international review. Each unit can only be used once—if Australia uses an international emissions reduction, then the selling country cannot use it and must therefore reduce its emissions by one tonne.

To provide additional flexibility, the Kyoto Protocol also established the CDM, which has operated since 2006 and has detailed rules and governance arrangements to ensure credited emissions reductions are genuine. Its operation has improved over time, and its Executive Board has made a concerted effort to identify and address environmental concerns. It now operates with a high level of environmental integrity, and has similar governance arrangements and verification processes to those planned for Australia's ERF (see Box 2.1).

The Kyoto Protocol gives each country flexibility to choose the units it will use. Australia could target its purchase of international emissions reductions to those with a high level of environmental integrity. The Authority's assessment of the environmental effectiveness of different types of eligible Kyoto Protocol units is presented in Chapter 3.

BOX 2.1: THE CLEAN DEVELOPMENT MECHANISM

Like the ERF, the CDM is a baseline-and-credit scheme where projects earn units by reducing emissions below a defined baseline. Project developers present plans and methodologies to the CDM Executive Board for its initial approval. The board must be satisfied the emissions reductions are 'additional' to what would have occurred without the project and that the project would not have occurred without the financial incentive provided by the CDM. The project must also be validated by an independent auditor to ensure the reductions are genuine, measurable and verifiable. The board must approve the project before CDM units can be issued. There are periodic independent reviews of projects to verify that emissions reductions occur.

The CDM Executive Board is supported by the United Nations Framework Convention on Climate Change (UNFCCC) secretariat, including its roster of experts and a number of specialist panels and advisory groups.

Many of the concerns raised about whether emissions reductions generated from the CDM are genuine relate to the question of 'additionality'—whether the reductions would have happened anyway. As with all baseline-and-credit schemes, this can be difficult to determine. Over time, the CDM has developed a sophisticated set of methodologies and rules to test whether reductions are additional and these are improved over time.

The CDM covers a large range of emissions reduction activities, including renewable energy, energy efficiency and the destruction of waste coal mine or landfill gas. Many of these are similar to the sorts of projects and activities the government expects to fund under the ERF. Where appropriate, CDM methodologies are expected to be adapted for use in Australia under the ERF.

2.2.2 CARBON MARKET FRAUD

If units are illegally issued or stolen, this can compromise the environmental integrity of the policy (if, for example, it results in the same emissions reductions being counted twice), as well as causing possible financial losses.

The risk of fraud exists as it does in most markets. Trading in financial and other goods and services, even in Australia, has some risks. The challenge is to manage their risks, not avoid markets which can deliver potential benefits.

Generally robust governance arrangements apply to these markets today. The Kyoto Protocol uses a system of electronic registries to issue and track all units. The rules governing these registries are subject to international oversight; the rules ensure that the correct number of units is issued and that they are not counted twice. In the case of the CDM, the registry is governed by the Executive Board and operated by the UNFCCC secretariat.

Some well-publicised incidents of fraud have occurred in the EU ETS. In 2010–11, about two million European units were stolen from individual accounts. The EU responded by immediately suspending trade in units until new security requirements were implemented. It also revised its systems to reduce the risk of similar events occurring—replacing the national registries of EU member states with a single EU-wide registry and tightening its rules on proof of identity. To further protect against fraud, the European Commission is aligning the rules governing the carbon market with other European financial markets.

2.2.3 AUSTRALIA'S TRANSITION TO A LOW-EMISSIONS ECONOMY

Deep cuts in global emissions are required if warming is to be kept below 2 degrees. A steady transition of the Australian economy could help improve Australia's long-term competitiveness in a more emissions-constrained world. If Australia relied too heavily on international emissions reductions (rather than reducing its domestic emissions), it could face a more costly and disruptive transition. Further, rapid and unexpected increases in the price of international units would make it more costly for Australia to meet its targets.

A mix of domestic and international emissions reductions therefore represents the best approach to meet Australia's goals, both to continue its transition to a low-emissions economy, and to help manage the risks of rapid and unexpected increases in the price of international units. In the short term, and particularly in the period to 2020 when the domestic opportunities for cost-effective emissions reductions are limited, it makes good sense for Australia to use some international emissions reductions.

The Authority considers a balanced approach to using international units to help meet Australia's targets offers significant benefits including lower costs and industry competitiveness, and in turn may help to drive stronger climate action over the years immediately ahead.