



# Tyranny of old ideas dogs ETS

*With small changes, the government's ETS could be more effective, writes Danny Price*

**J**OHN Maynard Keynes famously joked that "There is nothing a government hates more than to be well-informed; for it makes the process of arriving at decisions much more complicated and difficult."

The reaction to the release of Frontier Economics' research report last Monday suggests that the economist may have known a bit about politics, too.

Our research demonstrated that relatively small changes to the carbon pollution reduction scheme could deliver an unconditional cut by 10 per cent of 2000 emissions level by 2020, with a GDP saving of 40 per cent relative to the CPRS, and with manageable price increases to households and growth adjustments to the regions.

These findings have been met with scepticism in some quarters and outright hostility in others.

So let's start by separating opinion from fact. The first, and perhaps most important, point relates to cost. With any emissions trading scheme or tax there are two key costs involved. Until now, the government has only been willing to talk about only one of those costs. The costs the government will acknowledge are the direct costs of introducing a scheme. These are the costs associated with consuming resources to physically meet the greenhouse gas target. But as our research showed, these costs make up only about a quarter of the total economic costs of an ETS.

The second and much larger economic costs, and the costs the government seems to be pretending don't exist, are those associated with the knock-on effects of the introduction of a scheme. Adding a cost to householders and businesses for their impact on the environment will also impact on the economy. Householders respond by spending less. This reduces demand, and job growth slows. Businesses also respond by cutting costs, which will mean less demand for suppliers, and in some areas this will also mean cutting jobs. Less people with jobs will mean less demand, and so the cycle slows even further.

It's not all bad news, though. The CPRS will create green jobs and new

areas of growth. But the government has not adequately modelled any of this, and it certainly doesn't want to talk about it.

We have modelled it, because it's something we should all be talking about before we decide on any scheme. The government spent much of last week highlighting how it hopes to undo some of the damage its scheme will inflict on the Australian economy. It claimed householders would be more than adequately compensated for the enormous rise in energy bills it has promised. It also talked about how the big end of town, the large so-called energy-intensive, trade-exposed industries, are partly protected. But it's what the government didn't say about who in the economy will be left twisting in the CPRS wind that is most important.

The government's scheme will leave the small-to-medium enterprises exposed to much higher energy bills. Damage this heartland of Australian business and you can't avoid significantly damaging the economy.

The key difference between the CPRS and our proposal is that under our treatment of the electricity sector, these small-to-medium enterprises face only moderate increases in electricity costs over the short-to-medium term.

Our scheme avoids the rapid and sharp shock the government's CPRS will cause to the price of electricity.

The more orderly the transition, the less small and medium-sized businesses will go out of business. Our modelling shows the magnitude of the damage that will occur to small and medium-sized businesses if the government's CPRS were to come in.

And it's important to note that lower electricity prices do not mean that the carbon price itself has been muted. The underlying carbon price is the same under our proposal as under the CPRS. We simply change the way the carbon price translates into electricity prices.

Before explaining how this is achieved, it is worth responding to criticisms that taking the sting out of electricity is akin to environmental vandalism. A carbon price is meant to drive lower emissions by encouraging producers to embrace lower emission

technology. But a carbon price can only dampen demand to a point.

We believe the government has an overblown sense of the importance of the contribution of the demand side largely because it has made an arithmetic error in its modelling that overstates its importance by a factor of 10. It's also likely in practice that much of the expected demand side response will simply be industry leaving Australian shores to set up or increase production in countries overseas that will not have an ETS or carbon tax. This will not benefit Australia or the environment.

Having said this, no economist wants to lose the benefits of the demand side response. Our scheme does this by preserving the role of orderly rising prices to induce behavioural change, while creating a positive, financial inducement for customers who take earlier action to improve their carbon footprint.

Ours is a mixture of stick and carrot. The government's is all stick.

The government plans to charge the same carbon price to all generators whether they are high or low emitters. This will make all emitters, good and bad, more expensive and drive up the cost of electricity across the board. But this is one aspect to the scheme the government seems to like. Over the years the government's coffers will swell from an additional \$4 billion a year to \$20bn in the sale of permits. This will give it a lot of discretionary expenditure, and the political power that comes with it.

Our scheme largely leaves that cash in the economy where it creates jobs and growth. And despite what you have heard, our scheme is not a baseline-and-credit scheme where any generator producing fewer emissions than a baseline receives a credit the value of which is determined by the value of a permit.

The approach we propose, and have been proposing for some time, is one of the many variants possible on the classic cap and trade.

Like the CPRS, we propose a hard target (or benchmark) but we swing the economics in favour of cleaner generation two ways.



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First, we require generators who emit above the target in any year to buy permits for their “excessive” emissions. This raises the cost of high-emission generators, but only by a fraction of the cost of the CPRS because generators only pay for their excessive emissions.

At the same time, cleaner generators are rewarded by allowing them to earn permits they can sell into the market, including to higher emitting generators who need them. The permits are valued at the going carbon price, and the cleaner a generator is compared to the benchmark the more permits they

receive. This makes “cleaner” electricity cheaper and “dirtier” electricity more expensive, comparatively and in real terms.

There are plenty of other things people have misunderstood or chosen to misrepresent about our proposal. For example, there is a profound misunderstanding of the role freely allocated permits to industry have in helping manage the financial shock of an ETS and the effect on the carbon price signal and the incentives to reduce emissions. These issues need to be understood and properly debated.

Ultimately, the Frontier Economics

analysis was undertaken to inform policy development. It is probably fair to say we have detected an unwillingness to countenance alternatives, notwithstanding what is at stake.

But if a genuine solution is to be found, we need genuine debate. Or, to quote Keynes again, “The difficulty lies not so much in developing new ideas as in escaping from old ones.”

Danny Price, a founding managing director of Frontier Economics, has advised governments across the world for 20 years on energy and greenhouse policy.