Australian Government

Discussion Paper: King Review Safeguard Crediting Mechanism

submission

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Introduction

The Government's current consultation process on its proposed Safeguard Crediting Mechanism follows on from a key recommendation of the 2020 'King Review' into Australia's emissions reduction policies. The King Review Report recommended a 'below-baseline crediting arrangement' be established for large facilities using the Safeguard Mechanism architecture. The arrangement would provide credits to facilities who reduce their emissions below an emissions-intensity baseline by undertaking 'transformative' abatement projects.

CMI acknowledges the opportunity this arrangement could provide for facilities to better integrate emissions reduction considerations in investment decision making not facilitated by the Emissions Reduction Fund (ERF), however considers the proposal a missed opportunity for broader reform.

The discussion paper does not address reforms to the Safeguard Mechanism that could see it used as a strengthened policy lever to drive real industrial abatement through declining mandatory baselines that are aligned to Australia's long-term emissions reduction targets. This would be an evolutionary step using existing scheme architecture where industry investment could be more appropriately guided to facilitate the necessary transition to a net-zero emission economy. This policy evolution would see business as the primary driver of emission reductions, not the taxpayer backing the ERF and other technology development schemes. CMI's recently completed 2021 Climate Policy Survey of business attitudes found policy or regulatory uncertainty to be the primary barrier to decarbonisation or drawdown (sequestration) investment and again found over three quarters (79%) support mandatory baselines allocated under the Safeguard Mechanism being reduced over time in line with the trajectory of Australia's 2030 emissions reduction target. A similar number supported crediting for voluntary action but considered operational controls, declining baselines and short-term vintage/use limits of highest importance if such a change occurred.

The potential for the proposed policy measure to negatively impact the integrity and stability of Australia's current carbon market and carbon farming industry is also a key concern. If this is initiative is to proceed then clear limits should be applied on the use of these proposed Safeguard Mechanism Credits (SMCs) with additional requirements for integrity and transparency.

CMI has consulted with its membership across industry to develop its response to the Government's King Review Safeguard Crediting Mechanism Discussion Paper and our response is noted below. We note that the positions put forward are not representative of any CMI individual, member company, or industry sector.

Summary Positions

1. **A Safeguard Crediting Mechanism that creates new supply of emissions units should be accompanied by a clear, stable, and long-term demand signal, i.e. mandatory reducing baselines, that shifts the market from public to private-sector funding of transformational emissions reductions aligned with a transition to net-zero emissions by 2050 via stronger 2030 ambition.**

2. **The Safeguard Crediting Mechanism's proposed design is complex, and coupled with the small-scale public funding allocation for the pilot phase, is unlikely to achieve its stated objectives of incentivising transformational emissions reduction at low-cost or realising genuine abatement.**

3. **If an additional unit is introduced into Australia's carbon market under this arrangement (namely a Safeguard Mechanism Credit) it should only be available for creation, trade or use by Safeguard covered entities, for the purposes of compliance. Such units should not be fungible with ACCUs nor made available for trade or use by voluntary market participants.**

4. **Should the proposed Safeguard Crediting Mechanism pilot proceed, transparency and accountability guardrails should be embedded to prevent the scheme and its resulting credits from undermining the integrity of Australia's emissions reductions. These could include:**
    - A clear and ambitious definition of what constitutes a transformative abatement activity;
    - Limiting the trade and use of credits generated under the scheme only to Safeguard liable entities;
    - Adjusting reference baselines over time to reflect improved emissions-intensity performance;
    - Ensuring that Safeguard Mechanism baselines (if adjusted during the crediting period to reflect improved emissions-intensity performance) are not able to return to pre-project baselines;
    - Requiring transformation statements to demonstrate alignment with the goals of the Paris Agreement, or Australia's Nationally Determined Contribution (NDC) targets at a minimum;
    - Ensuring rules are embedded in the scheme's design to prevent the crediting of activities that reduce emissions intensity but increase absolute emissions at a facility; and
    - Measures to ensure minimal impact to investor certainty and market sentiment if the pilot scheme sees unsatisfactory uptake and is not continued.

5. **Noting the proposed Safeguard Crediting Mechanism's objective to incentivise the deployment of transformational low-emission technologies, due consideration should be given to alternative policy levers that value and encourage direct decarbonisation without creating market uncertainty. These could include:**
    - Continued improvements to the Emissions Reduction Fund and an ongoing focus on the development of new methods and enhancements to existing methods;
    - Strong energy productivity, efficiency and emissions intensity standards for large industrial facilities; and
    - Enhancement of investment in public-private risk-sharing models for low or zero-emissions technology.

1. **A Safeguard Crediting Mechanism that creates new supply of emissions units should be accompanied by a clear, stable, and long-term demand signal, i.e. mandatory reducing baselines, that shifts the market from public to private-sector funding of transformational emissions reductions aligned with a transition to net-zero emissions by 2050 via stronger 2030 ambition.**

The urgency of the transition required to achieve net-zero then negative emission economies necessitates a strong suite of complementary policies that seek to (i) drive high quality emissions reductions with strong integrity, transparency and accountability, (ii) clarify national decarbonisation investment pathways aligned with greater 2030 ambition and a long-term target of net-zero emissions by 2050, (iii) appropriately manage genuine trade exposed carbon leakage risks and (iv) ensure a just transition for affected workers, communities and broader business, and Indigenous stakeholders.

Creating a Safeguard Crediting Mechanism that generates additional supply of tradeable emissions units (SMCs) without a clear long-term demand signal, is unlikely to incentivise real, meaningful behavioural change and decarbonisation across the Australian economy. The demand signals emerging from the voluntary market, while welcome, are opaque, uneven, and may be evolving incongruently with international trade economic relationships driven by either domestic or global decarbonisation policies. The implications of, and for, carbon border adjustment mechanisms for example, are yet to be determined. In this context, consideration of an SCM without a clear, overarching policy direction that supports long term investment decisions will be unlikely to incentivise transformational change, place further pressure on public funds, and increase investor uncertainty in the domestic market.

The Government could evolve the current Safeguard Mechanism and related reporting and assurance frameworks by:

- Changing the role of the Safeguard Mechanism from merely limiting emissions increases, to driving emissions reductions across significant sections of the economy;
- Declining Safeguard baselines over time, at least in line with the ambition of Australia's NDC commitment (with appropriate treatment for relevant sectors, i.e. emissions intensive trade exposed (EITE) sectors, noting such sectors will increasingly be exposed to carbon-constrained policies in other countries and global markets over time); and
- Transitioning the Safeguard Mechanism to a more sophisticated and simpler baseline and credit trading scheme, as outlined in CMI's 2019 Options Paper. Such a transition would provide a clear economic investment signal to covered entities, align Australia's policies with those currently established or emerging within our top ten two-way trading partners, and support the creation of a more stable, low-risk market for increased domestic and foreign investment.

The ability to credit emissions reductions below baselines is a feature of more formal compliance carbon markets implemented in other global jurisdictions; an SCM could be a stepping-stone to further evolution of the scheme to drive emissions reductions. Without any clear political narrative that sets out the future role of this within the broader policy suite however, it is difficult to see the deeper purpose and value that an SCM will provide to Australia's short, medium or long-term decarbonisation efforts.

2. The Safeguard Crediting Mechanism's proposed design is complex, and coupled with the small-scale public funding allocation for the pilot phase, is unlikely to achieve its stated objectives of incentivising transformational emissions reduction at low-cost or realising genuine abatement.

A number of design elements are being proposed for the operation of the Safeguard Crediting Mechanism, with many options for consideration. Indeed, the scheme's design principles in the discussion paper are themselves subject to this consultation.

- Design Principle 1 reinforces the Mechanism's objective to encourage the deployment of transformational low-emission technologies in Australian industry and other sectors covered by the Safeguard Mechanism. Whilst the intent of this design principle is supported, we question whether this scheme, with its limited funding and pilot phase, is the most appropriate to achieve this outcome and whether other concurrent efforts underway that are improving and expanding ERF methods could provide such incentives to industrial facilities.

  We also recognise the important role that Government plays in continuing to focus its efforts on the development and deployment of emerging low-emissions technologies. We note that transformational technologies are unlikely to be available at low-cost, and that the initial allocation of public funding for this pilot may be better directed towards supporting step-change technologies that deliver transformational abatement.

- Design Principle 2 requires that the Mechanism encourages Safeguard facilities to realise low-cost emissions reductions in a way that maintains or increases international competitiveness. As major economies and organisations transition to a net-zero emissions future aligned to the Paris Agreement temperature goals, transitional support that improves the economic viability of abatement projects for emissions-intensive trade-exposed (EITE) facilities is important. We do question however whether alternative policy levers that value and encourage direct decarbonisation without creating market uncertainty could be explored to better facilitate the deployment of industrial abatement technologies (refer policy position 5).

- Design principle 3 requires the Mechanism to realise genuine abatement that provides value-for-money for abatement driven by Government and private purchase of credits. As mentioned above, there appears to be a disconnect between the current public funding allocation put towards the pilot scheme and what would likely be required for a transformative emissions reduction project at a facility. To drive abatement that would not have otherwise occurred in the absence of this scheme, the abatement should be appropriately valued to incentivise uptake.

  Further, we note that all ERF methods are required to meet the offsets integrity standard; legislated criteria that ensure carbon credits issued represent real abatement. The SCM proposed however, in seeking to provide a simple approach for industry adoption, is not subject to these criteria. This would bring into question the legitimacy and credibility of the abatement that would be achieved under the SCM.

  If the SCM, and project Transformation Statements are not subject to additionality criteria (as per the offsets integrity standard), there is a risk of public funds being mis-appropriated for activities that may represent business-as-usual operations, as well as the potential for claims of greenwashing which undermine the scheme's overall intent and reputation. Should the pilot proceed, we recommend this be an additional area of focus in order for there to be a better understanding of how these market risks will be mitigated.

- Design principle 4 indicates the Mechanism should have a simple design that builds on existing frameworks and minimises additional reporting. Introducing new requirements that sit alongside, although separate from, existing architecture under the current Safeguard Mechanism, appear to increase complexity and effort for future participants. The introduction of a new facility baseline ("reference level") that is different to current facility level baselines under the Safeguard Mechanism; uncertainty around what a "transformation statement" would involve; and the introduction of a new type of credit in the market that is not akin to an ACCU, are just some of the additional elements participants in this scheme will need to understand and manage.

  Those electing to participate in the scheme will likely be entities already managing Safeguard Mechanism obligations for one or more facilities, and some may also be engaging in the ERF undertaking projects at their facilities. The need for simplicity and reduced administration rather than a fragmented approach is important to encourage industry uptake and confidence in such a scheme.

Industry effort and agreement will be required to achieve an effective design for the scheme that is fit for purpose. In the context of the King Review recommendations and range of other regulatory and ERF reforms being proposed, the CMI questions whether this scheme is the most appropriate to achieve its stated objective and incentivise transformational low-emission technology deployment, or whether regulatory and industry efforts are better directed in more efficient and effective ways. Refer policy position 5 for discussion of alternative options.

3. If introducing an additional unit in Australia's carbon market under this arrangement (namely a Safeguard Mechanism Credit) it should only be available for creation, trade or use by Safeguard covered entities, for the purposes of compliance. Such units should not be fungible with ACCUs nor made available for trade or use by voluntary market participants.

Well-functioning, efficient markets often experience differentiation, with divergent prices representing the differing quality and/or additional characteristics provided by similar products. In the case of carbon markets, carbon units are generally differentiated by the quality/type of their measurement, reporting and verification standard, or the extent to which the buyer values the additional environmental, social, cultural and economic co-benefits supported by the abatement project. In this case, ACCUs are naturally fungible with a range of other international standard carbon credits that measure one tonne of CO_2 equivalent (tCO_2-e), as long as they also meet the quality requirements set out in the Government's offsets integrity standards.

SMCs are proposed to represent reductions in emissions intensity and be guided by a Transformation Statement that, with the high-level detail set out in the discussion paper, does not seem to be required to meet the Government's own integrity standards. Here, we are not comparing like for like, as SMCs and ACCUs represent different outcomes. It may be technically possible to calculate equivalency between an SMC and an ACCU, however as SMCs are unlikely to be held to the same level of rigour or environmental integrity as ACCUs, they should not be fungible – just as other non-ACCU carbon units might be excluded if they don't meet the same integrity standards.

Using SMCs for voluntary use within the Government's own Climate Active carbon neutral program for example, should not be allowed to offset other companies' emissions as the units do not meet the Government's own requirements for certification. To allow this would undermine the integrity of carbon neutrality claims made by companies and undermine the credibility of the program.

Allowing use of SMCs for broader trade and use by voluntary market participants is problematic for similar reasons. As the number of net-zero targets, and carbon neutral claims, products and services increase across the economy, so too grows the scrutiny on these announcements by investors, environmental groups and the media, seeking to uncover greenwashing, and particularly actions that delay critical decarbonisation.

Buyers of carbon credits are rapidly strengthening their due diligence processes, and placing high value on the integrity, transparency and accountability of the units purchased. This includes review of the project's additionality, conservatism, measurement, reporting and independent verification of data, financing and project management. The credibility of the standard used is also important; SMCs based on a transformation statement that do not adhere to these clear integrity standards, commensurate with those regulating ACCUs will not stack up. Fungibility would also undermine the integrity of the ACCUs themselves, and likely the credibility of the current domestic offset scheme.

There is a question of whether the creation of SMCs would negatively impact demand for ACCUs, particularly generated by projects supporting land-based climate repair, and those having additional environmental, social, cultural and economic co- benefits. Industry modelling has provided some detail, but the discussion paper provides no clear picture of whether the SCM is likely to generate high volumes of credits; the likely price the Government might pay through a Clean Energy Regulator reverse auction process; or whether there would actually be substantial volumes available for sale to voluntary market participants.

Given the integrity issues stated above, it is unlikely that voluntary demand would stimulate the market for SMCs; similarly without a clear policy signal that drives Safeguard compliance, these factors are unlikely to stimulate much supply of SMCs either.

Without clarity on these factors, the risk remains that SMCs represent a new low-cost, low-quality unit that could undermine or shock the existing ACCU market. It also risks diverting funding away from critical climate-repair activities that realise real financial, environmental, social, cultural and economic returns for regional and remote communities, including increasingly farmers, landholders and traditional owners. Furthermore, the possibility of a new unit creates uncertainty, and we are being advised by industry participants that this is already negatively impacting forward investment in large scale, longer-term ACCU generating projects, with investors waiting for clarity on price and integrity. This is delaying critical and timely climate action.

The risks, and issues raised above can all be managed if SMCs are available for trade and use only by Safeguard-covered entities and facilities, towards Safeguard Mechanism compliance. It is a function of other formal emissions trading schemes to use a range of allowances, offsets and credits, and so this could be allowed within the Safeguard Mechanism itself. This could be done with SMC percentage use limits, to ensure that SMC usage doesn't stifle investment in ACCUs, whilst also creating a supply of potentially lower cost units for compliance.

For Australia's emissions reductions to remain credible for investors, and to stand up to international scrutiny, the integrity of all domestic units must be transparent, additional, conservative and provide clear accountability in the form of measurement, reporting and independent verification.

4. Should the proposed Safeguard Crediting Mechanism pilot proceed, transparency and accountability guardrails should be embedded to prevent the scheme and its resulting credits from undermining the integrity of Australia's emissions reductions.

As currently proposed, the Safeguard Crediting Mechanism would result in the issuance of credits for transformative abatement projects that reduce emissions below an emissions-intensity baseline. In lieu of the current regulatory arrangements that are in place for the issuance of ACCUs (including the ERF's mandatory reporting and auditing requirements), credit issuance under this proposed scheme would be contingent on the submission of a transformation statement. The level of detail contained in these statements therefore will need to provide the market with confidence that the project undertaken has resulted in a significant reduction in emissions-intensity, and that abatement being credited is genuine. As noted above, we are yet to see detail on how this will be demonstrated with a credible level of assurance.

Achieving a balance between transparency and "regulatory burden" for participants could be challenging. As global markets seek to increase transparency, it is likely the information required in these transformation statements will also be expected to include a significant amount of detail such that market participants are confident in the integrity of the credit. The suggestion that those generating credits under this Mechanism could be subject to a duty of utmost good faith is one solution, however not aligned to the high standards currently applied in the ERF and expected by buyers.

Integrity guardrails should be considered to prevent any perverse outcomes that could undermine the credibility of the scheme and the emissions reductions associated with it and bring into question the use of public funding. The following options should be considered to minimise market shocks and prevent emissions from rising or stagnating at a time when they should be declining:

- A clear and ambitious definition of what constitutes a transformative abatement activity eligible under this scheme should be established to ensure activities undertaken are credible and public funding is not allocated for business-as-usual projects.

- Credits generated under the SCM should only be available for trade or use by Safeguard liable entities for the purposes of compliance and should not be fungible with ACCUs nor made available for trade or use by voluntary market participants (refer policy position 3 above).

- Reference baselines should be adjusted to reflect improved emissions-intensity performance over time and therefore encourage ongoing abatement activities that continue to improve emissions-intensity at facilities. A declining trajectory for these baselines could be aligned to Australia's Nationally Determined Contribution (NDC). This aligns to recommendation 3.3.3 in the Grattan Institute report[1] suggesting all baselines should start to decline in order to bend the emissions curve downwards and support the achievement of Australia's national emissions target.

- If Safeguard Mechanism baselines are adjusted during the crediting period (to reflect improved emissions-intensity performance) they should not be allowed to return to pre-project baselines. If facilities have the option to move back to an industry average default baseline, this provides only a one-off, short-term reward for emissions reductions, and may see absolute emissions increase, rather than ensuring that reductions are permanent and contribute to an overall net decrease in emissions over time.

[1] Towards net zero: Practical policies to reduce industrial emissions (August 2021) https://grattan.edu.au/report/towards-net-zero-practical-policies-to-reduce-industrial-emissions/

- Transformation statements could be required to show alignment with the goals of the Paris Agreement, as well as the targets at least as strong as Australia's Nationally Determined Contribution (NDC). Requiring alignment with such overarching market goals would help to clarify whether projects are focused on long-term emissions reductions or a shorter-term financial gain that may not result in the overall outcomes that the scheme is seeking to incentivise.

- Rules should be embedded in the scheme's design that prevent the crediting of activities that reduce emissions intensity but increase absolute emissions at a facility. The crediting arrangements of the SCM focus on reductions in emissions intensity, however, a facility may still increase its absolute emissions if production is increased. This would result in a perverse outcome whereby a facility would be credited for emissions reductions but increase its overall net-emissions.

- Measures to ensure minimal impact to investor certainty and market sentiment if the pilot scheme sees unsatisfactory uptake and is not continued. This could include embedding a review mechanism at the end of the pilot phase that includes discussion of options to evolve the role of the Safeguard Mechanism (as outlined earlier in policy position 1 of this paper).

5. Noting the proposed Safeguard Crediting Mechanism's objective to incentivise the deployment of transformational low-emission technologies, due consideration should be given to alternative policy levers that value and encourage direct decarbonisation without creating market uncertainty.

In its response to the recommendations of the King Review in 2020, the Government agreed to make a range of improvements to the Emissions Reduction Fund, including its agreement to set annual method development and improvement priorities. These developments include:

- 2020 ERF method priorities including a biomethane method (still under development), and a Carbon Capture and Storage (CCS) method, which came into effect 29 September 2021;
- Variations to the Coal Mine Waste Gas method that came into effect 29 September 2021; and
- Recent consultation on creation of a new Industrial and Commercial Emissions Reduction (ICER) method, to make improvements to and replace the existing Industrial Electricity and Fuel Efficiency (IEFE) method.

These developments may now obviate the need to develop a competing crediting mechanism. Furthermore, feedback from industry has been that even if SCM projects are undertaken, the credits resulting from the activity are unlikely to incentivise actual transformational change. It is noted that the business case for step change industrial emissions reduction projects are much more likely to be influenced by internal climate targets, investor pressure, carbon-constrained market access concerns, and potential future compliance liabilities. Given the small amount of funding of $279.9 million announced for the scheme's pilot round, industry participants have noted they would prefer a range of financial and other technology incentives. In the absence of a clear Safeguard compliance demand signal, alternative measures could include:

- Strong energy productivity, efficiency and emissions intensity standards for large industrial facilities, that provide a longer-term emissions reduction pathway, and incentivise transition to lower or zero-emissions facilities. This should include the alignment of various federal and sub-national policies, such as energy efficiency schemes implemented in Victoria and New South Wales. There could also be consideration of building more flexibility into the ERF Facilities method, to enable more activities to be undertaken at a single facility (currently not possible during a project's crediting period).

- Enhancement of investment in public-private risk-sharing models for low or zero-emissions technology. Such models allow industry to reduce the risk inherent in making emissions-intensive asset replacement decisions, particularly for early adopters looking to invest in demonstration-phase or feasible (but commercially unproven) technologies such as hydrogen or CCS. Risk-sharing models, such as those that see Government co-invest, or take a 'first-loss' provision on an investment for example, help to enhance commercial viability, improve design and delivery, support testing of complementary policies that enhance scale-up, and create an educative dialogue for the market about the negative externalities that must be managed if new technologies are to be deployed at scale.

  CMI notes the Government's recognition of these opportunities, as set out in its Technology Investment Roadmap, and first annual Low-Emissions Technology Statement - 2020. However, the lack of a long-term target (such as net-zero by 2050), obscures the incredible scale of technological and infrastructural change required, as well as the rapid pace of change that many sectors are also experiencing towards mid-century or earlier goals. This lack of a clear economy-wide trajectory makes it difficult for investors to understand when they should be investing in behavioural and/or asset change, or indeed the quantum of funding that would be required.

> CMI is supportive of recommendations made in the Grattan Institute's Towards Net Zero: Practical policies to reduce industrial emissions report, which endorses the establishment of an 'Industrial Transformation Future Fund' to generate the government funding that will be required to close the risk gap for transformational industrial investment'. This should not be an unfamiliar idea, noting such funds exist in other sectors, including drought, natural disaster assistance and public pension funds. The short-lived $800 million Clean Technology Investment Program (CTIP), established under the Gillard Government was a fund designed to support investment in energy-efficient equipment and low-emissions technologies, processes, and products for Australian manufacturers.

In the absence of a long-term policy signal, it is important that incentives to support industrial decarbonisation in particular for EITE facilities, are made available for organisations for a transitional period and that these are easily accessed, practical and simple in their design. Given the lack of clear long-term policy signals, the complexity of Safeguard Crediting Mechanism design, and the low level of public funding, it is unclear whether this Mechanism in its current form will see significant uptake by industry.

We also note that the timeline noted in the discussion paper for the commencement of the pilot phase (1 July 2022) appears ambitious given the myriad design elements subject to consultation and industry feedback, and any delays would undermine industry confidence in the mechanism and its objectives.

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The Carbon Market Institute is an independent industry association and centre of excellence with a 2050 vision of a prosperous, climate resilient, net-zero emissions world. Our mission is to help business manage risks and capitalise on opportunities in the transition to a net-zero emissions economy.

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