Department of Climate Change, Energy, the Environment and Water Safeguard Mechanism Reform – First Consultation

submission

September 2022

Carbon Market Institute

Department of Climate Change, Energy, the Environment and Water (DCCEW) Safeguard Mechanism Reform – First Consultation

CMI Submission

The Carbon Market Institute **(CMI)** welcomes the opportunity to respond to the Department of Climate Change, Energy, the Environment and Water's **(DCCEEW) Safeguard Mechanism reform consultation paper**, which was published on 18 August 2022.

CMI is an independent member-based industry association championing best practice for business in the transition to net-zero emissions. CMI's 140+ strong membership includes organisations from across the entire carbon value chain, including primary producers, carbon service providers, legal and financial institutions, technology firms and emissions intensive companies. CMI's Board annually updates CMI Advocacy Policy Positions in consultation with – but independent of – our members. The latest positions include support for policies aligned with Australia's fair share of effort to achieve the high-ambition Paris Agreement goal to pursue limiting warming to 1.5ºC, reductions of at least 50% by 2030 and evolution of the Safeguard Mechanism.[1] In preparing this submission, CMI engaged with a broad cross-section of our corporate membership across different sectors. The positions put forward constitute CMI's independent view and do not purport to represent any CMI individual, member company, or industry sector.

Strategic outlook

CMI strongly supports the Albanese Government's reform agenda to strengthen the Safeguard Mechanism into a declining baseline and credit scheme that will provide a supportive policy framework for industry's own commitment to net zero by 2050 (hereafter enhanced Mechanism).[2]

Since 2018, CMI has consistently advocated for baselines under the Safeguard Mechanism to be tightened to drive emissions reductions in the industrial sector and support Australia's Nationally Determined Contribution (NDC) targets under the Paris Agreement.[3] The Business Council of Australia (BCA), Grattan Institute and Australian Industry Group have all called for similar reforms.[4]

Despite being introduced to cap industrial emissions, emissions covered by the Safeguard Mechanism increased 4.3 percent between 2016-17 and 2020-21.[5] Business-as-usual (BAU) analysis suggests that without intervention, industrial emissions will overtake those from the rapidly decarbonising electricity sector

[1] CMI 2021 'Advocacy Policy Position Statement 2021'
[2] ALP 2021, 'Powering Australia', p. 30.
[3] See: CMI 2018, 'Climate Change Authority: NGER Legislation Review Submission'; CMI 2018, 'Exposure Draft Amendments: Safeguard Mechanism Rule Consultation'; CMI 2019, 'Climate Change Authority Review: Meeting the Paris Agreement Submission'; CMI 2020, 'Australian Government response to the Expert Panel Review (King Review): CMI Position'; CMI 2021, 'Australian Government Discussion Paper: King Review Safeguard Crediting Mechanism Submission'; CMI 2021, 'CMI Policy Advocacy Position Statement 2021'; and CMI 2022, 'Climate Change Authority Review into the use of international offsets under Commonwealth programs submission'.
[4] Business Council of Australia (BCA) 2021, '*Achieving a net zero economy*'; Grattan Institute 2021, '*Towards net zero: Practical policies to reduce industrial emissions*'; Australian Industry Group 2022, '*2022 Federal Election policy statements: Energy and climate*'.
[5] CMI & RepuTex 2022, 'Potential futures for Australia's Safeguard Mechanism', p. 10.

by 2024.[6] As outlined in the Consultation Paper,[7] the government is reforming the Safeguard Mechanism so that it is fit for purpose to deliver large-scale, low-cost emissions reductions and support Australia's recently legislated, higher-ambition 2030 NDC. [8]

At its core, the enhanced Mechanism should be designed to drive industrial decarbonisation in order to strengthen Australia's competitiveness in a carbon-constrained global economy. As noted in CMI's Post-election Briefing[9] complementary policies and investments will also be required alongside the Safeguard reforms to enable this transition. While we appreciate that the ALP's Powering Australia Plan contemplated some of these complementary policy measures, further consultation will be required to clarify the relationship between these interlinking policies and their ability to support the Government's economy wide target.[10]

CMI supports the government's proposed design principles that the reforms are effective, equitable, efficient and simple. However, we consider the reforms should also be guided by an additional design principle of scalability. The enhanced Mechanism should be scalable to support ratcheting climate ambition into the future. Australia's 2035 NDC is due in 2025 and must represent a progression in ambition compared to the 2030 NDC, as stipulated by the Paris Agreement's ratchet mechanism.[11] Therefore, while it is appropriate to assess whether the enhanced Mechanism can facilitate a sufficient share of abatement to support the 2030 NDC, it is also important that its framework allows this portion to be scaled to support increased ambition into the future.

CMI would also support an ongoing process of regular review, with clearly communicated timeframes to support investor confidence. This review process should track and assess the Safeguard Mechanism's performance and inform decisions on scaling its share of abatement over time. The framework of the evolved mechanism should also be amenable to further reform. This is particularly important, given these reforms are happening in the context of broader domestic policy change – with the ongoing independent review of Australian Carbon Credit Units (ACCUs) – and evolving Article 6 rules on international carbon markets under the Paris Agreement.

CMI maintains that an economy-wide carbon pricing compliance mechanism with declining limits is the most efficient and effective use of carbon markets to drive decarbonisation.[12] Nevertheless, we recognise the potential for the enhanced Mechanism as a pragmatic first step and welcome the opportunity to provide this submission to its first consultation period. We note that there are significant interdependencies between Safeguard Mechanism policy elements and outcomes. We appreciate that alternative options to those recommended below may also be able to support delivery, but these will need to be examined carefully at the next stage of consultation.

[6] CMI & RepuTex 2022, 'Potential futures for Australia's Safeguard Mechanism', p. 4.
[7] DCCEW 2022, 'Safeguard Mechanism Reforms: Consultation paper', p. 5.
[8] In June 2022, the Albanese Labor Government submitted Australia's updated NDC to the United Nations Framework Convention on Climate Change (UNFCCC). The new 2030 NDC targets a 43 percent reduction in emissions based on 2005 levels, compared to the former target of 26-28 percent.
[9] CMI, Post-election briefing: 5 Priorities for climate action and carbon markets, Available at https://carbonmarketinstitute.org/app/uploads/2022/05/CMI-Post-Election-Briefing-5-priorities-for-climate-action-and-carbon-markets.pdf.
[10] CMI 2022 'Post-election Briefing: 5 priorities for climate action and carbon markets'
[11] UNFCCC 2015, 'Paris Agreement' (Article 4), p. 4.
[12] See CMI 2018 , 'Climate Change Authority: NGER Legislation Review Submission.

Summary positions

CMI has carefully considered the matters raised in the Consultation Paper, as well as the role of the enhanced Mechanism in supporting the government's climate targets and its ability to scale climate ambition into the future. With a view to ensuring that the enhanced Mechanism is both effective and scalable, we make the following recommendations:

1. **The initial share of national abatement allocated to the enhanced Mechanism and rate of baseline decline should represent a floor, not a ceiling, on industrial decarbonisation. Baseline decline rates should be aligned with efforts to pursue limiting global warming to 1.5°C, in line with the Paris Agreement. CMI therefore supports decline rates at the highest end of the Consultation Paper's suggested range of up to 6 per cent, with CMI Research suggesting an initial decline rate of 5.6 per cent would best support an emissions reduction trajectory aligned with a 1.5°C warming scenario.[13] These should be scaled and accelerated in line with Australia's ratcheting ambition under the Paris Agreement. The rate of decline should be complemented by an absolute carbon budget for the enhanced Mechanism.**

2. **A production-adjusted (intensity) framework should set baselines using facility-specific emissions-intensity values, with strict best-practice benchmarks for new entrants. We consider this approach is best suited to removing aggregate headroom from the scheme and allow it to achieve emissions reductions in Phase 1 and beyond.**

3. **The enhanced Mechanism should incentivise industrial decarbonisation such that covered facilities emerge as leaders in very low and zero carbon industrial processes and can prosper in a carbon-constrained global economy. This will require tightening legacy flexibility measures available under the current framework of the scheme and protecting against perverse outcomes such as facility upgrades that lock in long-term emissions.**

4. **Support for Emissions Intensive, Trade Exposed (EITE) facilities should be provided to reduce genuine risks of carbon leakage resulting from the enhanced Mechanism. To avoid distorting the scheme-wide signal to decarbonise, EITE support should be outside the enhanced Mechanism. In the medium term, the government should consider developing a carbon border adjustment mechanism (CBAM) to further support the competitiveness of lower-emitting Australian industrial products and reduce the risk of carbon leakage.**

5. **The enhanced Mechanism should be implemented such that scheme coverage can expand in a phased approach, beginning in 2025. This will allow the government to scale Australia's climate ambition beyond the 43 per cent 2030 NDC when it sets the 2035 NDC in 2025, and subsequent NDCs thereafter. To inform this phased approach, the government should develop market design analysis on the optimal market approach to supporting scaled decarbonisation in the electricity sector; the potential to, and impacts of, extending the Safeguard to facilities below the 100,000 tCO_2-e threshold to 25,000 tCO_2-e, and any further necessary guidance. Drawing upon this analysis and in consultation with industry, the government should clarify no later than January 2024, its intended approach to scaling the enhanced Mechanism.**

[13] CMI & RepuTex 2022, '[Potential futures for Australia's Safeguard Mechanism]', p. 20.

6. **CMI supports evaluating the use of international credits in future phases of the enhanced Mechanism. While we agree with the Consultation Paper's intention to exclude international credits from use in the initial phases, legislative amendments should be undertaken now to facilitate the future use of international carbon credits at these later stages.**

7. **The government should clarify the role for third-party intermediaries to facilitate efficient trade and transfer of Safeguard Mechanism Credits (SMCs) among Safeguard-covered entities in its detailed policy proposal and exposure draft Rule, to be released for consultation later in 2022. Market rules should not permit fungibility of ACCUs and SMCs outside the Safeguard Mechanism.**

8. **The government should set up and communicate a process of ongoing, iterative review of the enhanced Mechanism to ensure it is delivering abatement and continues to improve and ratchet in ambition over time, as appropriate, in line with industry's capacity to reduce emissions and Australia's ratcheting NDCs.**

We elaborate our **Recommendations** over the page and provide responses to the questions raised in the Consultation Paper in the **Attachment**.

Should you have any questions about CMI's submission, please contact **Gabriella Warden**, Manager, Research and Government Relations, at gabriella.warden@carbonmarketinstitute.org.

Yours sincerely

Kurt J Winter

Kurt Winter

Director, Corporate Transition

CMI recommendations

1. **The initial share of national abatement allocated to the enhanced Mechanism and rate of baseline decline should represent a floor, not a ceiling, on industrial decarbonisation. These should be scaled and accelerated in line with Australia's ratcheting ambition under the Paris Agreement.**

With emissions from Safeguard-covered facilities set to overtake the electricity under a BAU scenario, these reforms should send a clear investment signal for entities to decarbonise, while giving them flexibility to address their emissions investing in abatement activities through an evolved carbon crediting framework.

Ensuring that emissions from Safeguard-covered facilities make up the same proportion of economy-wide emissions in 2030 as they do currently, instead of growing, should be the *minimum* achievement of the enhanced Mechanism, with this proportion reviewed and increased over time to support and drive Australia's ratcheting NDC targets.

Baseline decline rates should be aligned with efforts to pursue limiting global warming to 1.5°C, in line with the Paris Agreement. CMI therefore supports decline rates at the highest end of the Consultation Paper's suggested range of up to 6 per cent, with CMI Research suggesting an initial decline rate of 5.6 per cent would best support an emissions reduction trajectory aligned with a 1.5°C warming scenario.[14]

The rate of decline should be complemented by an absolute carbon budget for the enhanced Mechanism.

CMI Research shows that a 'slow start' to declining baselines would require steep declines – in excess of 6 per cent – to 'catch up' and keep aggregate scheme emissions within the original carbon budget.[15] A slow start should therefore be avoided, as it would make future compliance more difficult while constraining the scheme's potential to scale its proportion of abatement and support Australia's ratcheting ambition beyond 2030.

Decline rates and any subsequent updates to these should be applied evenly across scheme participants with additional support and policy applied where necessary to address real carbon leakage or competitiveness issues (we elaborate further under Key Recommendation 4).

2. **A production-adjusted (intensity) framework should set baselines using facility-specific emissions-intensity values, with strict best-practice benchmarks for new entrants. This approach is best suited to removing aggregate headroom from the scheme and allow it to achieve emissions reductions in Phase 1 and beyond.**

CMI is not against returning the Safeguard Mechanism to a fixed (absolute) framework – indeed, this would align with international practice and is the best approach under an economy-wide carbon pricing compliance mechanisms like emissions trading systems (ETSs).

However, CMI Research[16] shows that maintaining a production-adjusted (intensity) approach accommodates cyclical production variability for industrial facilities. Therefore, CMI supports a production-adjusted (intensity) framework so long as the enhanced Mechanism remains a sectoral policy for industry.

If a production-adjusted (fixed) framework is maintained, facility-specific emissions-intensity values are preferred to industry average values because this is a surer, faster way of removing headroom from the

[14] CMI & RepuTex 2022, 'Potential futures for Australia's Safeguard Mechanism', p. 20.
[15] CMI & RepuTex 2022, 'Potential futures for Australia's Safeguard Mechanism', p. 20.
[16] CMI & RepuTex 2022, 'Potential futures for Australia's Safeguard Mechanism, p. 43.

scheme, which will allow SMC trading to commence and give an incentive for all facilities to reduce emissions intensity in Phase 1.[17] While we appreciate alternate views on the ability of the industry average approach to effectively manage the abatement task, we consider that this will be highly dependent on whether the declining baseline is set at a sufficiently ambitious level. If Government is minded to prefer an industry average approach, a strong baseline decline rate will be required.

International best-practice intensity variables should be assigned for new entrants to counterbalance the risk that their production may grow and soak up a disproportionate amount of the enhanced Mechanism's carbon budget;[18] these best-practice variables should decline at the same rate as facility-specific variables for existing entities to ensure the rate of baseline decline is spread evenly among covered facilities.

Regular review should include review and potential revision of facility-specific emissions-intensity values to ensure that aggregate baselines are declining and on track to meet (or ideally exceed) point-in-time targets and remain within (again, ideally below) the industrial sector's allocated carbon budget.

Limits to SMC creation could be considered if aggregate absolute emissions covered by the enhanced Mechanism increase under a production-adjusted (intensity) framework.

3. **The enhanced Mechanism should incentivise industrial decarbonisation such that covered facilities emerge as leaders in very low and zero carbon industrial processes and can prosper in a carbon-constrained global economy. This will require tightening legacy flexibility measures available under the current framework of the scheme and protecting against perverse outcomes such as facility upgrades that lock in long-term emissions.**

The Government should limit banking provisions for SMCs (i.e. permitted only within the same phase or five-year rolling period).

Borrowing provisions should also be prohibited or restricted, as it would be difficult to ascertain how 'creditworthy' borrowing facilities might be; borrowing can also create perverse incentives for facilities to delay decarbonisation in early years.[19]

The ability for facilities to apply for multi-year monitoring periods and other flexible baseline setting provisions afforded under current Safeguard Mechanism arrangements should be removed, as these can have similar impacts to borrowing provisions.

CMI supports the Consultation Paper's proposal to grandfather deemed surrender arrangements for existing ERF registered and contracted projects such that they can continue to issue ACCUs for the crediting period. Rules should be established to ensure facilities generating ACCUs are not generating SMCs from the same activities until the crediting period of the current ACCU project phases out.

The government should explore options for de-risking investment in emerging very low- or zero carbon industrial technology, in addition to providing funding support through Powering the Regions Fund (PRF) grants and financing from the National Reconstruction Fund (NRF). Some options include:

[17] CMI & RepuTex 2022, 'Potential futures for Australia's Safeguard Mechanism, p. 34.
[18] CMI & RepuTex 2022, 'Potential futures for Australia's Safeguard Mechanism, pp. 44-45.
While production at existing facilities varies, this variation is cyclical and therefore balances out between years so does not present the same risk that new entrants – whose production is often growing in early years – pose to the overall scheme's carbon budget.
[19] Many international ETSs have, for these reasons, limited borrowing allowances; risks associated with borrowing are further detailed in: International Bank for Reconstruction and Development & The World Bank 2016, 'Emissions Trading in Practice: A handbook on design and implementation', pp. 98-100.

- Underwriting investments in new technologies with the potential to unlock step changes in emissions-intensity at industrial facilities; and
- Establishing competitive public grant funding and/or financing to support research and development for transformational technology opportunities, administered through the Clean Energy Finance Corporation (CEFC) and/or Australian Renewable Energy Agency (ARENA).[20]

The Government should permit opt-in to the enhanced Mechanism for below-threshold industrial facilities to extend incentive to create SMCs to smaller entities.

Fit-for-purpose penalties should also be established for non-compliance in a way that ensures they exceed the cost of procuring ACCUs or SMCs, or pursuing at-source structural abatement, and that they continue to increase in line with the increasing cost of carbon.

Incentives to decarbonise processes should avoid perverse outcomes, such as facilities investing in upgrades that reduce emissions-intensity in the short-term but lock in emissions over a longer period.[21] Consideration must be given to ensure that facilities are not incentivised – neither through government funding, nor through the creation of Safeguard Mechanism Credits (SMCs) – to upgrade to 'lower' emissions processes that will actually lock in emissions in the long term – e.g., upgrading from a coal- to a gas-fired furnace.[22]

4. **Support for Emissions Intensive, Trade Exposed (EITE) facilities should be provided to reduce genuine risks of carbon leakage resulting from the enhanced Mechanism. To avoid distorting the scheme-wide signal to decarbonise, EITE support should be outside the enhanced Mechanism. In the medium term, the government should consider developing a carbon border adjustment mechanism (CBAM) to further support the competitiveness of lower-emitting Australian industrial products and reduce the risk of carbon leakage.**

Under past definitions, EITE facilities comprise 118 of the 215 Safeguard-covered facilities and 78 percent of covered emissions. Inappropriate exemptions would distort the scheme-wide decarbonisation signal.[23] Instead, the government should support EITE facilities to 'contain' the cost of compliance so that their operational costs remain manageable, and they are not forced to shut down (which may lead to carbon leakage). On the other hand, giving EITE facilities exemptions, carve outs, differential monitoring periods, or allowing the special use of international credits would require other non-EITE facilities to overcompensate or else risk distorting the scheme-wide signal to decarbonise, e.g. by diluting carbon prices, ultimately reducing decarbonisation drivers across the scheme.[24]

To minimise the risks of distorting the scheme-wide signal to decarbonise, CMI suggests EITE assistance measures including the following:

- priority access to funding support for transformational upgrades through the financing mechanisms outlined in Recommendation 3; and

[20] See for example the Grattan Institute' recommendation to establish a $10 billion Industrial Transformation Future Fund to help kickstart R&D for transformational technology and further close the risk gap for step-changing industrial upgrades. Grattan Institute 2021, 'Towards net zero: Practical policies to reduce industrial emissions'.
[21] For example, a coal-fired alumina facility transitioning to being gas-fired may reduce emissions comparatively in the short term, but then lock in emissions for the lifetime of the new upgrade – see more in: CMI & RepuTex, 'Potential futures for Australia's Safeguard Mechanism', p. 42.
[22] These risks are illustrated in CMI & RepuTex 2022, 'Potential futures for Australia's Safeguard Mechanism', p. 28.
[23] CMI & RepuTex 2022, 'Potential futures for Australia's Safeguard Mechanism', p. 52.
[24] CMI & RepuTex 2022, 'Potential futures for Australia's Safeguard Mechanism', p. 52.

- if the government decides that EITE facilities require additional financial assistance to meet their compliance obligations, this should be provided through a refund mechanism that supports facilities to recoup the cost of procuring SMCs or ACCUs on the back end, rather than assistance up-front or direct provision of credits.

In the medium term, the government should consider developing a carbon border adjustment mechanism (CBAM), that aligns with comparable economies and key trading partners. Similar to the EU CBAM, an Australian CBAM would reduce the risk that carbon leakage might pose to Australian industry by encouraging facilities in other countries to reduce the emissions-intensity of their production processes. It could also generate additional revenue that the government could use to further support Safeguard-covered facilities to decarbonise.[25] We consider it appropriate that this is developed over the next 3-5 year time horizon.

5. **The enhanced Mechanism should be implemented such that scheme coverage can expand in a phased approach, beginning in 2025. This will allow the government to scale Australia's climate ambition beyond the 43 per cent 2030 NDC when it sets the 2035 NDC in 2025, and subsequent NDCs thereafter. A 2025 starting year for this expansion aligns with the scheduled commencement of Phase 2 of the reformed scheme.**

CMI reiterates that an economy-wide carbon pricing compliance mechanism such as an ETS is the most efficient use of markets to drive decarbonisation. While we appreciate that the current consultation is framed within the parameters set in the Powering Australia Plan, we recommend the government immediately commence further consultation on how the mechanism could be scaled to cover smaller industrial facilities and whether it should be applied to adjacent sectors, notably the electricity generation sector.

Expanding coverage of the scheme should be guided by robust analysis on the abatement opportunity, balanced against the administrative burden expanded covered may impose. In the case of smaller industrial facilities, it may be appropriate that they be phased into the scheme from 2025 onward to provide appropriate lead time. For the electricity sector, it will also be necessary to develop appropriate baselining methodologies.

Before the commencement of Phase 1 of the reformed scheme on 1 July 2023, we would urge the government to develop market design analysis on:

- The optimal market approach to supporting scaled decarbonisation in the electricity sector, having regard to existing national and state-based energy policy frameworks (including the Renewable Energy Target (RET) that is due to conclude in 2030, Rewiring the Nation policy and state renewable energy frameworks) as well as alternative schemes that are currently in development, including the Guarantee of Origin. This analysis should inform consideration of the potential benefits of incorporating energy into the Safeguard as compared with other approaches.
- The potential to, and impacts of, extending the Safeguard to facilities below the 100,000 tCO_2-e threshold and potentially dropping the eligibility threshold to 25,000 tCO_2-e (to align with reporting requirements under the NGER Act 2007) to ensure that all industrial facilities are subject to consistent market regulation that incentivises decarbonisation.
- The need for any guidance on use of ACCUs or SMCs. Strong decline rates are the best way to guide decarbonisation investment and simplicity in scheme design is preferred over initial arbitrary limits not informed by experience of the scheme in operation. There are competing views in CMI's membership Some point to experience that such new markets tend to oversupply in tradeable credits

[25] See, for example: Moersdorf, G 2022, '*A simple fix for carbon leakage? Assessing the environmental effectiveness of the EU carbon border adjustment*', *Science Direct*; L'Heude, W, Chailloux, M & Jardi, X 2021, '*A carbon border adjustment mechanism for the European Union*', *Tresor-Economics*.

and that there is a large pool of ACCUs available through carbon abatement contract exit arrangements facilitated by outgoing Minister Taylor. Others argue the pool may be shallower if the growing voluntary market, outside of the compliance enhanced Mechanism, and other factors take effect. We should hold off guidance on ACCU or SMC use till we see the scheme in operation, but we should be vigilant supported by strong decline rates.

Drawing upon this analysis and in consultation with industry, we would recommend the government clarify a phased approach to expanding the enhanced Mechanism no later than January 2024. CMI notes that if electricity generators are not brought into the enhanced Mechanism, another sectoral policy for electricity should be introduced to drive accelerated decarbonisation beyond the conclusion of the RET in 2030.

6. **CMI supports evaluating the use of international credits in future phases of the enhanced Mechanism, noting that the eligibility of these credits (ITMOs or A6.4ERs only)[26] would be contingent on emerging international law guidance. While we agree with the Consultation Paper's intention to exclude international credits from use in the initial phases of the enhanced Mechanism, amendments to the National Greenhouse and Energy Reporting (NGER) Act 2007 should be undertaken now to facilitate the future use of international carbon credits at these later stages**.

7. **The government should clarify a role for third-party intermediaries to facilitate efficient trade and transfer of Safeguard Mechanism Credits (SMCs) among Safeguard-covered entities in its detailed policy proposal and exposure draft Rule, to be released for consultation later in 2022. Market rules should not permit fungibility of ACCUs and SMCs outside the enhanced Mechanism.**

8. **The government should set up and communicate a process of ongoing, iterative review of enhanced Mechanism to ensure the reformed mechanism is delivering abatement and continues to improve and ratchet in ambition over time, as appropriate, in line with industry's capacity to reduce emissions and Australia's ratcheting NDCs.**

Regular review of the enhanced Mechanism settings will be important to ensure that aggregate baseline decline is on track to meet, and ideally exceed, point-in-time targets.

CMI supports the Consultation Paper's suggestion that a review be scheduled at the conclusion of phase 1 of enhanced Mechanism – to guard against any unintended, perverse consequences – with reviews to then continue on a five-yearly review cycle that is aligned to the Paris Agreement NDC cycles. As part of this review, the Government should consider:

- Whether a production-adjusted emissions intensity model remains appropriate or whether the enhanced Mechanism should be adapted to an absolute emissions approach; and
- If the scheme is expanded to cover electricity generation, whether Safeguard facilities should be prohibited from participating in future electricity generation ERF projects.

[26] Internationally Transferred Mitigation Outcomes (ITMOs) are emissions reductions that will be traded under bilateral Article 6.2 arrangements, while A6.4ERs are carbon credits that will be created and traded on the new Article 6.4 market mechanism that will replace the Kyoto-era Clean Development Mechanism (CDM). For more information on Article 6, see: CMI 2021, 'COP26 Key Takeaways: Article 6 Explainer'.

Attachment: CMI responses to specific consultation paper questions

Section	Question	CMI response
2. The Safeguard Mechanism's share of the national abatement task	What should the Safeguard Mechanism's share of Australia's climate targets be?	The initial share of national abatement allocated to the enhanced Mechanism and rate of baseline decline should represent a floor, not a ceiling, on industrial decarbonisation. As elaborated under Recommendation 1 of CMI's submission, we support an initial baseline decline rate in Phase 1 on the higher end of the Consultation Paper's 3.5-6 per cent range. This ambitious decline rate should be complemented by an absolute carbon budget allocated to the enhanced Mechanism. An ongoing review and revision process should ensure that the absolute carbon budget allocated to the enhanced Mechanism is not breached. At the same time, the proportion of abatement allocated to the enhanced Mechanism should be reviewed and scaled over time to support Australia's ratcheting economy-wide NDCs. CMI notes that it may be appropriate for this proportion to represent more than industry's 'fair share' of abatement and rather reflect the level of abatement the industry is able to deliver as emissions-efficiency gains are stimulated by the scheme over time. Setting a more ambitious share of abatement for the industrial sector will provide stronger drivers for decarbonisation. Incentives under the ERF have seen other sectors' share of national emissions reductions – notably, the land sector – well-exceed what is proportionate. The same can be done by industry under a well-designed, ambitious Safeguard Mechanism.
3. Setting baselines to achieve an equitable distribution of costs and benefits	Should we retain, and build on, the existing production-adjusted (intensity) baseline setting framework or return to a fixed (absolute) approach?	For the enhanced Mechanism as a sectoral policy targeting industrial facilities, either a production-adjusted (intensity) or fixed (absolute) approach can work so long as appropriate market rules and review periods are included. If a production-adjusted (intensity) framework is adopted, as this may be viewed as suited to the cyclically variable nature of production at facilities, CMI would prefer intensity variables to be set at the facility level (see Recommendation 2).

		To mitigate the risk that a production-adjusted (intensity) framework might lead to absolute increases in emissions that could jeopardise point-in-time targets, CMI recommends protections include: • Regular review should include revision of facility-specific emissions-intensity values to ensure that aggregate baselines are on track to meet (or ideally exceed) point-in-time targets; and • Limits to SMC creation could be considered if aggregate absolute emissions covered by the enhanced Mechanism increase under a production-adjusted (intensity) framework. Further detail on this is given below.
	Views are sought on the proposal to reset baselines in a way that removes aggregate headroom so crediting and trading can commence when baselines start to decline.	We consider that the surest and fastest way to remove aggregate headroom within the enhanced Mechanism under a production-adjusted framework, is by setting baselines using facility-specific emissions-intensity values. Under a fixed (absolute) framework, headroom can be removed by starting baselines at either using facility-specific emissions-intensity values or reported annual emissions. For each of these approaches, facility-specific emissions-intensity values or reported emissions should be calculated based on an average of a spectrum of years.
	What is the preferred approach for setting baselines for existing facilities? Approaches may include: • Option 1, which would see all baselines set using industry-average benchmark values. • Option 2, which would see all baselines set using facility-specific emissions-intensity values. Other proposals, noting there are many possible approaches.	If a production-adjusted (intensity) baseline setting framework is adopted, we consider that Option 2 (facility-specific baselines) is preferable, given that: • This option is the surest, fastest way of removing aggregate headroom to allow SMC trading to begin and incentivising industrial decarbonisation; and • This option creates a decarbonisation driver at all facilities that is based on individual circumstances. To avoid unfairly penalising early movers that have made investments in emissions-intensity efficiency upgrades in recent years, we would suggest that starting values/baselines should be an average of historical values. A trimmed average is one option for calculating these values, whereby the average emissions-intensity value over the facility's lifetime in the enhanced Mechanism could be calculated by trimming off year(s) on either end. This method must be applied to all facilities in the same way to ensure a fair and equitable approach. While we appreciate alternate views on the ability of the industry average approach to effectively manage the

		abatement task, we consider that this will be highly dependent on whether the declining baseline is set at a sufficiently ambitious level. If Government is minded to prefer an industry average approach, we consider that an even stronger baseline decline rate should be adopted to ensure that any potential headroom washes out of the scheme quickly.
	What are the advantages of best practice, industry average benchmarks, or alternative approaches for baselines for new entrants, noting that a final decision will be informed by baseline setting arrangements for existing facilities?	New entrants should have best practice intensity values applied at the facility level. If new entrants are given the same intensity variables as existing facilities, there is a risk that large increases in production might see these new facilities using up significant amounts of the aggregate carbon budget allocated to the enhanced Mechanism overall. This would either jeopardise point-in-time targets or unfairly increase the share of work required by existing facilities. Special care should be taken when it comes to expansion of production at existing facilities, as well. These best-practice values must decline at the same rate as the facility-specific emissions-intensity values applied to existing Safeguard covered facilities. More detail on these points is found under Recommendation 2.
4. Crediting and trading, domestic offsets and international units	Are there any other issues to consider with the proposal to allow the Clean Energy Regulator to automatically issue tradable credits to Safeguard facilities whose emissions are below their baseline, with crediting and trading commencing on 1 July 2023 subject to baseline setting arrangements that remove aggregate headroom?	CMI reiterates its support for the Department's proposal to remove aggregate headroom from the scheme to trigger trading of SMCs. We agree that the continued presence of headroom would mean that trades do not represent any reduction of actual emissions.

	Should banking and borrowing arrangements be implemented for Safeguard Mechanism Credits?	While CMI supports some flexibility arrangements being established within the enhanced Mechanism, these arrangements should carefully balance the need to drive structural decarbonisation in Australia's industrial sector against measures that may ease the cost of transition. The enhanced Mechanism's design should guard against enabling liable entities to bank cheaper SMCs in the Phase 1 transitional period in order to meet compliance obligations in subsequent periods. Similarly, the scheme should prohibit or restrict borrowing provisions which risk delaying decarbonisation investments decisions in the earlier periods. CMI considers that the design should: • Permit banking of SMCs only within each phase of the scheme and prohibit carryover between periods (in phase 1 transitional period and then within each rolling 5 yearly phase aligned to the Government's NDC policy suite); • Prohibit or restrict the borrowing of SMCs to mitigate the risk of short-sighted cascading borrowing practices, which could reduce scheme's overall effectiveness[27] and • Remove the ability for facilities to apply for multi-year monitoring periods and other flexible baseline setting provisions afforded under current Safeguard Mechanism arrangements, as these can have similar impacts to borrowing provisions. See Recommendation 3 for more details.
	Should Safeguard facilities no longer be able to generate ACCUs for reducing direct (scope 1) emissions unless they have an existing registered ERF project? Further, should no new ERF projects be able to be registered at Safeguard facilities? Additional feedback is sought on: • **allowing existing ERF projects at**	CMI supports the Consultation Paper's proposal to grandfather existing ERF projects such that they can continue to issue ACCUs for the crediting period. Rules should be established to ensure facilities generating ACCUs are not generating SMCs from the same activities until the crediting period of current ACCU project phases out. CMI recommends that deemed surrender arrangements be phased out with appropriate grandfathering arrangements for existing registered and contracted activities. We recommend that the government continue to purchase ACCUs for the duration of these facilities' crediting period, in line with the above. Longer term, these facilities should not be able to use these credits to meet their compliance requirements under the enhanced Mechanism.

[27] Many international ETSs have, for these reasons, limited borrowing allowances; risks associated with borrowing are further detailed in: International Bank for Reconstruction and Development & The World Bank 2016, 'Emissions Trading in Practice: A handbook on design and implementation', pp. 98-100.

	Safeguard facilities to continue to generate credits and retaining double counting provisions to prevent a facility from generating ACCUs and SMCs; • options for the treatment of deemed surrender; • continuing to allow Safeguard facilities to participate in ERF projects that reduce emissions from electricity use (scope 2) emissions; and mechanisms to promote the transparency of the ACCU market, such as publishing unit holdings, to assist with market decision making, supply and cost effectiveness.	It may be appropriate for Safeguard facilities to have scope to participate in ERF projects that reduce emissions from electricity use, given that Scope 2 emissions (from electricity) are not included in Safeguard liability. However, if scheme coverage expands to Scope 2 emissions or include electricity sector, then they should not be able to. CMI recommends the government to consider this as part of its milestone review in 2025. CMI supports mechanisms to improve transparency in the ACCU market, and will make more detailed comment on suggestions for this in our submission to the Independent ACCU Review Panel's parallel consultation. However, it is not clear whether this proposal to publish ANREU unit holdings would apply to only Safeguard covered facilities or to all who hold ACCU market CMI notes that any decision on making ANREU unit holdings public should be considered and consulted on more broadly than the targeted Safeguard Mechanism Reform consultation process.
	Should international units be able to be used for compliance under the Safeguard Mechanism at a future time, noting that any decision would depend on the rules for international trading?	CMI notes that some facilities have requested use of international units to meet liability under reformed Safeguard. CMI strongly supports the Consultation Paper's proposal that international units should not be eligible for use by Safeguard covered facilities in the initial phase of the enhanced Mechanism. We stress that the use of international units should also not be considered as a provision for EITE facilities as this would distort the scheme-wide signal to decarbonise (see Recommendation 4 for further details). Australia moreover reduce the Safeguard Mechanism's function as a driver towards Australia's NDC (as international units, unless traded under A6 with corresponding adjustments applied, would instead count to the NDC of the project host country). Australia has a deep, liquid ACCU market, comparative to the very nascent market that existed when the former Carbon Pricing Mechanism was established to include provisions for

		the use of international units, and these considerations are no longer necessary or appropriate for inclusion under the enhanced Mechanism Mechanism's design.[28] Further, international credits traded on the voluntary market are significantly cheaper than ACCUs – so allowing these to be used by facilities would not only not contribute to Australia's NDC, but also reduce the driver for at-source emissions reduction investments However, in line with CMI's Recommendation 6, CMI supports amending the NGER Act 2007 now to ensure the enhanced Mechanism is future facing and includes provisions that will allow for the future use of international carbon credits. We note that the eligibility of these credits would be dependent on Article 6 guidance, including the requirements around corresponding adjustments. [29] CMI notes that updating Australia's institutional and regulatory infrastructure for participation in Article 6 was also a key recommendation of the Climate Change Authority's review of international offsets. [30]
5. Tailored treatment for emissions-intensive, trade exposed (EITE) businesses	Should a facility-specific comparative impact assessment that builds on existing EITEs definitions be used rather than a sector wide designation?	CMI would caution the government against introducing further complexity into the enhanced Mechanism framework. Instead, CMI suggests that the government focus on supporting EITEs to manage the cost involved with compliance while leaving EITE definition as it is (see Recommendation 4 for details). • priority access to funding support for transformational upgrades through the financing mechanisms outlined in Recommendation 3; and • if the government decides that EITE facilities require additional financial assistance to meet their compliance obligations, this should be provided through a refund mechanism that supports facilities to recoup the cost of procuring SMCs or ACCUs on the back end, rather than assistance up-front or direct provision of credits.

[28] CMI & RepuTex 2022, 'Potential futures for Australia's Safeguard Mechanism', pp. 48-49.
[29] More detail at: CMI 2021, 'COP26 Key Takeaways: Article 6 Explainer'.
[30] Climate Change Authority 2022, 'Review of International Offsets', p. 26.

	Would additional funding opportunities effectively assist EITE facilities to adapt to declining Safeguard baselines? **What kinds of funding, finance or other arrangements and measures would best support EITE Safeguard facilities to reduce their emissions?** **In particular, what potential design features of the Powering the Regions Fund would support covered facilities with their decarbonisation priorities?**	Additional funding opportunities is one way to assist EITE facilities to adapt to declining Safeguard baselines, and one that CMI has supported as above and in Recommendation 4. However, CMI again stresses that eligibility criteria is carefully implemented to ensure that government funding and support is not provided for facility upgrades that might lock in long-term emissions. Again, we point to the example of a coal-fired facility that switches to gas; this is lower-emissions in the short to medium term, but will lock emissions in over the lifetime of this new upgrade, which could be worse overall.[31] When it comes to potential design features of the Powering the Regions Fund, CMI notes that the remit of this fund (as outlined in Powering Australia) is broader than just the enhanced Mechanism. Therefore, we suggest that the government should consult more broadly than through the dedicated Safeguard Mechanism Reforms consultation on this question. Please also see Recommendation 3 for CMI's suggestions on how financing and support for facility upgrades can be de-risked by the government. .
	Is the direct provision of SMCs an appropriate way to mitigate cost impacts for EITE facilities?	CMI cautions the government against directly providing SMCs to EITE facilities to support them with compliance. As detailed in Recommendation 4, this carries the potential risk of distorting carbon pricing and thus warping the scheme-wide signal to decarbonise. As an alternative, CMI would support setting up a refund mechanism that would allow EITEs to apply for compensation for part of the cost of compliance at the back end instead of direct SMC provision. This could take the form of, e.g., a tax credit.[32]
	Are differential decline rates an appropriate way to reduce the impact on EITE facilities? **How could differential decline rates be structured so that emissions reduction and fairness outcomes are maintained?**	We consider this would distort market signals to decarbonise. Our preference is for complementary policies outside of the enhanced Mechanism to manage EITE exposure (see Recommendation 4). Similarly, we do not consider that differential decline rates should be applied to EITE facilities. There are ways to support these facilities to transition without distorting market signals

[31] Again, see example in: CMI & RepuTex, 'Potential futures for Australia's Safeguard Mechanism', p. 42.
[32] CMI & RepuTex 2022, 'Potential futures for Australia's Safeguard Mechanism', p. 54.

6. Taking account of available and emerging technologies?	Should multi-year monitoring periods be extended to allow facilities with limited near-term abatement opportunities to manage their own abatement path?	No – for the same reason that borrowing provisions should be limited or approached with caution (outlined in Recommendation 3). While CMI recognises that many industrial facilities do not yet have technology that will allow them to structurally decarbonise, there are no limits on offsetting proposed for the scheme as yet – therefore it would be inappropriate to extend the multi-year monitoring period provision to facilities. We note that this type of baseline-setting flexibility is the reason why covered emissions under the Safeguard, despite its intention to cap industrial emissions, have grown by over 4 percent since the scheme was introduced in 2016.[33]
7. Indicative baseline decline rates	What are the appropriate characteristics for the decline trajectory to 2030 that can deliver the Safeguard Mechanism's share of Australia's climate targets, and the process for setting baselines post-2030?	As detailed in Recommendation 1 and higher up in the table, CMI would support an initial baseline decline rate in Phase 1 on the higher end of the Consultation Paper's 3.5-6 per cent range. An ongoing review and revision process should allow these decline rates to be accelerated and updates in line with industry's capacity to decarbonise and to support Australia's ratcheting economy-wide NDCs.
8. Other policy issues	What transitional or other arrangements should be in place for site-specific production variables, including: • whether the use of Government-defined production variables (prescribed in Schedule 2 of the Safeguard Mechanism Rule) should be mandatory from the start of Phase 1; • whether transitional arrangements	No comment

[33] CMI & RepuTex 2022, *Potential futures for Australia's Safeguard Mechanism*, p. 10.

	for facilities using bespoke, site-specific production variables should be considered for phase 1; and • the proposal that only Schedule 2 production variables could generate Safeguard Mechanism Credits (SMCs)?	
	Should oil refinery production variables: • remain fixed (in Schedule 3) and not generate SMCs; or • become production-adjusted (move to Schedule 2) and be eligible to generate SMCs? Under either approach, oil refinery baselines would decline at the same rate as other facilities.	No comment
	Are existing Government-defined production variables suitable for the Safeguard Mechanism to drive least cost emissions reductions?	CMI prefers a facility-specific, emissions-intensity approach to setting declining baselines under a production-adjusted (intensity) framework under the enhanced Mechanism.
	Should the inherent emissions variability calculated baseline approach be removed?	No comment

	How should landfills be treated, including: • should landfill baselines decline at the same rate as other facilities; • should landfills be able to generates SMCs in phase 1; and should long-term arrangements for landfills be considered prior to phase 2?	No comment

for more information please contact

Gabriella Warden

Manager, Research and Government Relations

gabriella.warden@carbonmarketinstitute.org

+61 (0) 418 263 296

+61 (03) 8601 1142

The Carbon Market Institute is at the centre of climate change policy and business in Australia. Independent and non-partisan, we bring business, policy makers and thought leaders together to drive the evolution of carbon markets towards a significant and positive impact on climate change.

Engaging leaders, shaping policy and driving action, we're helping business to seize opportunities in the transition to a low carbon economy.

Carbon Market Institute