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Speech to the CEDA State of the Nation Conference

Canberra, Friday 6 June 2008

'Tackling climate change with real economic reform'

Introduction

Thank you for the invitation to join you here at the CEDA State of the Nation conference.

I want to acknowledge the traditional owners of this land, the Ngunnawal people.

It's very appropriate that we talk about climate change here at this conference on Australia's economic development, because our future economic development will depend in large part on how successfully we deal with climate change now.

I think it's fair to say that in general, climate change has conventionally been seen as an environmental issue.

Let me be absolutely clear: this Government believes climate change is an economic issue, and the only way to tackle climate change is with real economic reform.

How Australia responds to the threat of climate change is a crucial test of economic management.

The arguments about what climate change will do to our natural environment have been well canvassed.

But what is much less well understood is the extent to which climate change puts our prosperity at risk.

Consider, for a moment, our agricultural industry. Climate change and associated drought put our agricultural exports – worth \$27 billion a year - at great risk. In one recent year alone, the drought caused farm production to fall by \$6.2 billion.

Consider also that in investing \$12.9 billion in our long term Water for the Future plan, the Rudd Government is actually investing in adaptation to a changing climate with less rainfall. Over \$10 billion of that is being invested in improvements to the health and functioning of our rivers, which is, of course, crucial for agricultural industry.

But it's not just agriculture that suffers because climate change means less rainfall. Consider estimates by the Victorian Government that the price of water for homes and businesses in Melbourne will double over the next five years – reflecting the cost of infrastructure to provide new supplies of water.

Consider as well the fact that 80 per cent of Australians live in coastal areas – and these numbers are growing fast. There are around 711,000 addresses at risk – that is, buildings within three kilometres of the coast and less than six metres above sea level. Best estimates show that \$25 billion in assets may be at risk from sea level rise and storm surge.

This is just a small sample of the economic impact of climate change.

The old political approach was wilful neglect: governments denying the problem or wringing their hands and saying that a country Australia's size couldn't possibly take on this global threat. The old political approach was to favour short term political interests over long term nation building.

And the old approach ignored the stark reality that climate change is the biggest threat we face to our economic prosperity and way of life.

Responsible government is live to the task. Responsible government understands that the question is not what to do if climate change is coming – the question is how to deal with the climate change that is coming. We have no choice but to take on this threat. Our task may be unprecedented in every way – but we simply must succeed.

It is the job of the national Government to help prepare Australia for the challenges of the future.

As the Treasurer has said:

"The job of economic policy makers is...about recognising that in economics the future belongs to the most open, adaptive and inclusive nations."

That means undertaking the real economic reform that will enable Australia to compete in a world economy that is going to be reshaped by climate change.

It means taking the tough and responsible decisions today so that Australian businesses and families can move to a low carbon future, ready for what lies ahead.

Climate change and economic reform

Widespread industrialisation over the centuries has spurred a wave of long term economic growth that has benefited billions of people all over the world.

However, this widespread industrialisation has also spurred another huge wave, climate change, which is now in rapid advance.

This historical fact demonstrates why we need to see climate change as an economic issue. We need to see it as a failure of markets. To borrow from Sir Nicholas Stern: “this is the greatest market failure the world has seen”.

Put simply, the market has failed to price the impact of carbon on the economy. Now this failure is coming home to roost; all kinds of industry are grappling with the fact that there is in fact great cost for them in a changing climate.

The insurance industry, for example, is facing the reality that 85 per cent of the largest 40 catastrophes since 1970 happened between 1988 and 2006, with about 38 per cent just since 2000. According to Allianz, the majority of these large claims have been related to natural catastrophes.

So what is the solution?

The failure has been in the market. The market has not priced in the economic impact of the relentless release of carbon into the atmosphere.

Therefore, we need to reform the way the market works, so that we can harness all its power in the pursuit of carbon emission reductions.

We need a system of capping our emissions, trading emissions within the cap, and reducing the amount of emissions that can be produced over time - a robust, competitive carbon market. That is, we need an Emissions Trading Scheme.

This real economic reform will move Australia to a low carbon economy – at the lowest cost to business and families.

Carbon productivity

For some time, one of the major economic challenges around the world has been to increase productivity.

This imperative has driven economic reform in many countries. In Australia, the Rudd Government's economic agenda is firmly about reversing twelve years of neglect and building our long term productive capacity: through investment in education in skills; through investment in infrastructure; through our tax system.

As the Deputy Prime Minister said this week:

“Today’s productivity growth is the nation’s future prosperity.”

At its most simple, we have a finite pool of resources, so if we are to going to achieve the economic growth necessary to assure our prosperity, we need to find ways to make the most of the resources we have.

The threat of climate change has led the world to a new frontier of economic reform: increasing carbon productivity.

We cannot keep creating carbon emissions at this rate forever. We must keep growing, but we also must do more with what we have.

As the world moves towards targets of emissions reductions, the question faced by all nations will be: how do we reduce our carbon intensity while maintaining strong economic growth.

To make sense of this question we need to change the way we think about economic growth and productivity.

With our economy growing while our use of carbon is constrained, we must increase our output per unit of carbon emitted - our carbon productivity.

Our task is to improve that carbon productivity.

As a recent paper by McKinsey & Company on global carbon productivity makes clear, it is a substantial task.

Last year's Intergenerational Report projected Australia's annual growth to average 2.4 per cent over the next 40 years. Our national output will be more than \$2.5 trillion by mid-century.

To meet our responsible 60 per cent reduction target our carbon productivity will need to improve much faster than any improvements we have seen in recent decades.

Improving our carbon productivity

There is no doubt that increasing our carbon productivity is a fundamental part of responsible economic management.

This is the only way we can continue to grow our economy over the long term, for the benefit of all Australians.

In this emerging global contest, Australia cannot choose to be a spectator – we must be on the field.

Through emissions trading we are creating the scarcity and the competitive market that will drive a new era of carbon productivity.

There are four specific imperatives in improving carbon productivity that I would like to emphasise.

The first three are borrowed from Nicholas Stern, who identifies each over a different timeframe.

First, we must deploy existing low carbon technologies. Harnessing the potential of existing low-carbon technologies is a crucial and urgent first step.

Second, we must develop and scale-up technology that is near commercialisation. Low-carbon technologies like carbon capture and storage and innovative solar technologies that still fall short of commercial viability will require effective cooperation between governments, investors and the private sector to accelerate development and deployment.

Third, we must find the big breakthrough technologies. In the longer term, the global cuts in carbon emissions will be achieved only through fundamental technology breakthroughs such as zero-emission electricity. That will mean a major investment in research and development.

However, these three imperatives are not the whole story. They are important, but just as important is the imperative for many companies and industries to change the way they operate. This imperative is a business decision. Those who improve their carbon productivity will find greater success. And, of course, this in turn will impact on the economy as a whole, shifting it to a low carbon future.

Managing this change in a way that deals with legitimate community concerns is the tough job of real economic reform that this Government is prepared and willing to take on through the ETS.

Emissions trading

The ETS is the economically responsible, market driven approach to move towards a low carbon future and spur innovation.

With the ETS, we are placing a limit – or a “cap” – on the emissions we will allow to be produced. Permits will be issued up to the level of the cap and each year firms would surrender to the Government a number of permits equal to their emissions.

This will produce a market for permits, which will be actively traded and will attract a price. It is this price – “the cost of carbon” – that will change the way that decisions are made throughout the economy. Companies that can easily reduce emissions will do so to avoid this cost, thereby freeing up permits for those companies who have fewer opportunities to reduce their emissions.

This approach enables us to make informed choices for ourselves, but equally it forces us to account for our carbon emissions. It means we are responsible for what we put into the atmosphere. Obviously, this imposes a cost – but it is a necessary one.

Australians see the impact that climate change is starting to have and they recognise that tackling climate change will not be easy. But Australians also understand that there is no cost free option. It is true that emissions trading will have an impact on different prices in the economy. However, doing nothing certainly won't save us any money: the cost of continued neglect is far greater than the cost of responsible action now.

Getting this reform right takes careful, methodical work. The work being done by Professor Garnaut and the modelling by Treasury, as well as our extensive consultations at every stage, will enable the Government to make the necessary, responsible decisions in the interests of all Australians. These decisions will be finalised later in the year, after consultation on our Green Paper.

However, I have made it clear that in designing the ETS, the Government is applying certain principles. To summarise, it will

- be a cap and trade scheme;
- be designed to place Australia on a low emissions path in a way that best manages the economic impacts of transition while assuring our ongoing economic prosperity;
- have maximal coverage of greenhouse gases and sectors to the extent that is practical;
- be designed to enable international linkages, while ensuring it suits Australia's economic conditions.
- address the competitive challenges facing emission-intensive trade-exposed industries in Australia; and
- address the impact on strongly affected industries.

In addition, I have made it clear that measures will be developed to assist households, particularly low income households, adjust to a carbon price.

The ETS and investment certainty

The four imperatives of carbon productivity I have just outlined - deployment of low-carbon technology; commercialisation of proven technology; zero-emissions technological breakthroughs; and moving companies, industry and the economy to a low carbon future - all depend on long-term investment decisions.

And in turn, those long-term investment decisions depend on a credible and effective carbon constraint.

A credible trajectory and a credible emissions trading scheme are essential economic reforms that give the certainty to drive investment in clean energy. That's because the transformation to a low-carbon economy will require substantial investments in long-lived assets.

If we don't deliver a scheme that will credibly reduce Australia's emissions, then the market — that is, the investors and firms, such as energy suppliers and technology companies, that we'll depend on to cut Australia's emissions — won't commit to the new energy assets we need to reduce our emissions.

By contrast, if we do get the ETS right, the market will channel the ingenuity and creativity of businesses and individuals to turn climate change to Australia's advantage.

Fundamentally, investment is driven by an expectation of future returns. We are asking entrepreneurs and investors to drive a massive economic transformation. We need a robust, credible carbon market so that those entrepreneurs and investors will have a certain economic environment for the life of those investments.

ETS design

Recognising the scale of this task, over recent months, the Department of Climate Change, the Treasury and I have been engaged in intensive work and consultation on scheme design.

These discussions with business and community leaders have been extremely valuable for me and for the officials in the Department as we strive to achieve the best policy outcome.

I'm grateful to those who have contributed their time and energy to our deliberations. We have used these – rightly – as a frank evaluation of the most important design issues.

It is clear to me from my discussions that business is well and truly on board with the need to tackle climate change. Business understands that it will be a tough economic reform, but recognises the necessity of a market based transition to a low carbon future. It is also clear that business wants to tackle climate change at least cost and avoiding regulation as much as possible.

But it would be dishonest to pretend that there are not great challenges here, both for the Government and for business.

Many businesses would like compensation for their circumstances. These are very difficult decisions indeed. While I am very conscious of each case in isolation, these circumstances need to be considered alongside the Government's responsibility to the economy and the community as a whole.

The broadest practical coverage means the work of reducing emissions is shared and occurs at the lowest possible cost to businesses and families.

This is the approach favoured by economists, most businesses and business advocates - including the Business Council of Australia and the Australian Chamber of Commerce and Industry – as well as community groups and climate advocates.

The point is this: the more emissions intensive industries who aren't making a contribution to emissions reductions through the ETS, the more "work" needs to be done by those industries are making a contribution.

In addition, the more compensation or free permits given to some firms, the harder it is for others.

And the more narrow the coverage – and the more compensation or free permits the Government provides - the less capacity we have to assist families.

None of the decisions are isolated. They are all linked. Giving relative priority to one or another inevitably involves a trade off.

It boils down to what is the most economically responsible design. The more we adjust the ETS to suit particular interests, the less robust and credible the carbon market will be.

I fully understand the position that some shareholders in some industries are in when it comes to emissions trading – and the challenge this in turn poses for management. But the Government must be equally mindful of the position of managers and shareholders across the economy.

The Government knows it has to get the right balance and it has to do so on the basis of economically responsible policy in the national interest. That's why we have engaged in this careful and methodical process, before finalising our decisions later in the year.

Opportunities

Tackling climate change through a robust, competitive carbon market is not just about minimising costs – although it certainly achieves that objective.

In fact, there will also be winners – and the biggest winners will be the early adaptors.

Putting a price on carbon will provide the necessary incentive to create ingenious new ways of reducing emissions. The ETS will create new opportunities: for growth; for innovation; for improved carbon productivity – for the jobs of the future.

Australia has the resources to exploit in clean energy, the great companies to respond with new products and ways of doing business; and households who are acutely aware of the need to act on climate change and who are willing to do something about it.

The global response to climate change has been characterised by the development of new technologies, such as carbon capture and storage, wind, geothermal and solar generation and clean coal.

But increasing carbon productivity really is a new frontier, with enormous opportunity yet to be conceived, let alone realised.

Our reform today has the potential to yield massive returns for Australia.

Markets versus regulation

Nevertheless, the reform will be difficult, so I'd like to be able to stand here with a menu of easier options for tackling climate change. But there is no such menu.

The economics of climate change have an inexorable logic for both sides of politics. Despite this, and despite the fact that the Liberal Party has traditionally been a strong advocate of the market, in recent times their economic responsibility has been found wanting.

At the National Press Club last month, Malcolm Turnbull said:

“... We can get a better result by encouraging and driving greater fuel efficiencies.”

Let's be clear: Mr Turnbull is referring to what is most plainly described as regulation. It beggars belief that he would be arguing that regulation alone will somehow be more effective than a market solution.

The truth is, Mr Turnbull doesn't believe his own argument. That's why he recently said in the House:

"We believe in free markets and we believe that competition will get consumers the best deal."

This debate will be littered with temptation for the Opposition. They may choose to continue with the old short term politics – and they will score some points along the way.

But any attempt by the Opposition to undermine the integrity of the ETS will expose their economic credentials to serious question.

Conclusion

The question for all of us is, are we here for short term political gain, or are we here for Australia's long term economic future.

As the Prime Minister has said,

"We recognise this will involve some hard decisions, but if we're serious about preparing Australia for the long term climate challenge, we must make difficult decisions now."

This is economic reform in the great tradition of Labor reforms like trade liberalisation.

By opening our economy, we took on the challenge of globalisation directly. With tough measures like tariff reform and floating the dollar, we created new industries and made existing industries more efficient.

We can do this again. Australians are an innovative people.

Through our creativity and skills, we can harness the full potential of our natural assets and human resources to turn the challenge of climate change to our advantage.