

## **CARBON LEAKAGE REVIEW | SECOND CONSULTATION PAPER**

Australian Energy Producers | 5 December 2024

Australian Energy Producers welcomes the opportunity to provide input into the Australian Carbon Leakage Review's second consultation document.

**Natural gas is critical to Australia's economy, including as the largest energy source for Australia's manufacturing and industrial sectors.** Natural gas is central to manufacturing in Australia, as a key energy source and essential feedstock to a range of industries, including cement, ammonia and chemicals, steel, and glass production – the same commodities facing a material risk of carbon leakage. Ensuring a reliable gas supply is essential to keeping Australia competitive in these sectors.

**Australian natural gas supports emissions reductions across the economy and the region.** Natural gas supports the transition away from coal, provides the firm dispatchable energy required to unlock large-scale renewable energy deployment, and powers Australian industries critical to net zero. Australian liquified natural gas (LNG) is central to the decarbonisation efforts of our partners in the region.

**Should Australian natural gas become less competitive internationally, it risks leading to carbon leakage with increased emissions in Australia and the region.** The natural gas sector risks being exposed to both import- and export-based carbon leakage. If Australian LNG cannot compete in the region, trading partners will turn to higher-emission sources of LNG or back to coal. If Australian manufacturers cannot access the natural gas they need domestically, industries will move offshore or turn to higher emissions intensity LNG imports.

### **Australian Energy Producers recommends:**

- To fully address carbon leakage, both import-competing and export-competing sectors must be treated equally.
- A Border Carbon Adjustment (BCA) mechanism must be carefully designed to align with the Safeguard Mechanism (SGM) and existing national and international measures and regulations.
- The 2026-27 SGM review should be used to inform government decisions on a BCA, including how the SGM can address both import- and export-based carbon leakage.
- Revising SGM rules to recognise emissions reductions from off-site low-emissions power (Scope 2) should be prioritised prior to the implementation of a BCA, as it risks disadvantaging Australian facilities compared with international competitors.
- Fee-based compliance is preferred to ensure sufficient Australian Carbon Credit Units (ACCUs) are available for SGM compliance.
- Design and implementation of a BCA should not be rushed, with consideration given to a phased implementation starting with high-risk commodities (e.g. cement)

**Australian Energy Producers welcomes further engagement in the consideration of carbon leakage.** This submission complements Australian Energy Producers submission to the first Carbon Leakage Review consultation paper.

## AUSTRALIAN ENERGY PRODUCERS' COMMENTS AND RECOMMENDATIONS

Australian Energy Producers supports the principles of a BCA as one measure (among many) to help facilitate equitable global emissions reductions, while also encouraging a wider uptake of international carbon pricing.

### *Carbon leakage considerations for Australian natural gas and LNG production*

**Australian LNG producers' exposure to import- and export-based carbon leakage can change rapidly** | Australian LNG exports are currently exposed to a low risk of being displaced by imports. However, there is one LNG import terminal under construction and more under consideration. LNG import terminals could increase the risk of import-based carbon leakage by displacing domestic LNG with higher-emission LNG imports from countries with less stringent climate policies. This would only serve to erode Australia's industrial base and undermine its and our trading partners' pathways to achieving net zero.

**LNG producers face heightened risks of export-based carbon leakage** | Australia's LNG competitors are significantly scaling up their production capacity – including in the United States and Qatar. The IEA projects in its World Energy Outlook 2024 substantial growth in LNG export capacity of nearly 50% expansion by 2030, driven by new projects in North America, Africa, and Asia. It is reasonable to presume that these regions will not operate under a comparable climate policy regime as Australia over the period to 2030 and potentially beyond. This could make Australia and LNG less competitive, leading to economic losses and potentially shifting domestic production to less-regulated markets.

These countries not only produce higher-emission LNG, they also are further from the region meaning additional emissions associated with transport to Asia. As production in these regions ramps up, it is likely to exacerbate export leakage risk for Australian LNG producers if these higher emissions producers encroach on Australia's LNG market share.

**To fully address carbon leakage, both import-competing and export-competing sectors must be treated equally.** A review is necessary to ensure both import-competing and export-competing sectors are treated symmetrically, and not just focus on import leakage as indicated in the discussion paper. Consideration of the LNG sector will be a key part of such a review.

### *A Border Carbon Adjustment mechanism must take into account the broader regional and national energy, industrial and climate context*

**A BCA must be designed within the context of the evolving global climate regime, including sunset provisions for when the mechanism may no longer be needed** | Over 90 per cent of global gross domestic product (GDP) is now under net zero commitments. It is plausible that with an effective implementation of global commitments, and Australia participating in international emissions trading – through the now fully operationalised Paris Agreement Article 6 – the need for a BCA diminishes over time. It would be prudent to include sunset provisions into the design of a BCA.

**A stringent 2035 emissions reduction target could exacerbate carbon leakage risk** | A tightening of Australia's 2035 emissions reduction targets could further exacerbate carbon leakage risks. An increased

emissions reduction requirement would see the SGM's annual baseline decline rates necessarily steeper post-2030, from the current -4.9% per year to 2030. This could make SGM integration with a BCA even more complex, especially with regard to trade-exposed sectors not protected under a BCA or by SGM's Trade-exposed Baseline Adjusted (TEBA) arrangements.

**A BCA must not duplicate or contradict Australian trade, industry and energy policies and objectives.**

The consultation document emphasises a core function of a BCA as assisting 'the emergence of zero emissions export industries', promoting green products (i.e., steel and ammonia), establishing green premiums, and supporting government programs provisioned under the Future Made in Australia (FMIA). It also cites that a BCA is not a mechanism for 'shielding existing high emissions processes from change.'

All sectors need to be afforded every opportunity to transition efficiently over the next 26 years to net zero. This is factored into the recent SGM reforms where all covered sector baselines are on a trajectory to zero in 2049-50. A BCA should avoid therefore serving as a defacto industry or climate policy that bestows advantage to one, narrowly defined 'green' domestic industry over others that continue to innovate and strive to abate their emissions. It should also not seek outcomes that run counter or contradict current policy and regulatory settings, including, for example, the Future Gas Strategy.

*A Border Carbon Adjustment mechanism must be carefully designed and integrated with the Safeguard Mechanism and other domestic climate policies*

**A BCA needs to be carefully integrated with existing climate policies, especially the SGM** | The integration of the BCA with domestic policies, particularly the SGM requires careful planning. It is considered appropriate that the review's focus on the provisions and compliance costs of the SGM, as the policy cornerstone for Australia's large-scale industrial reduction obligations. The SGM's production variables for the gas sector are deemed trade-exposed and so are eligible for TEBA.

The role and fate of TEBA under a BCA remains a priority issue. TEBA helps mitigate the risk of carbon leakage by adjusting annual allowable emissions baselines at a lesser decline rate than would otherwise occur. In the presence of a BCA, an import-competing facility could potentially rely less on TEBA assistance by optimising policy costs across domestic and foreign producers. However, export-competing sectors not covered under a BCA, as indicated by the review, may well require continued TEBA support (or similar). This should be further assessed in the review, especially with the suggestion that TEBA could be discontinued with the introduction of a BCA.

It is recommended that the government use the upcoming SGM review in 2026-27 to fully inform government decisions on a BCA and how policies can be refined and harmonised to ensure its effectiveness. The SGM review already contains provisions to consider a BCA, as outlined in the explanatory note on SGM reforms. This is especially the case regarding the SGM's provisions for trade-exposed production variables (TEBA), a growing national risk of import leakage from future LNG imports, and apply equal focus to both the risks of import and export leakage.

**The incentive for facilities to transition from on-site gas power production to off-site renewables is limited under the SGM; this could further disadvantage a facility under a BCA.** As it currently stands, if a SGM facility moves from on-site gas power production to off-site renewables, the facility loses its on-

site power generation baseline, and therefore the benefit from the resultant emissions reductions is not adequately credited to the facility. This is despite those emissions being eliminated both inside and outside the SGM. In contrast, an SGM facility that can replace on-site higher emissions power with on-site lower emissions power, keeps their on-site power production baseline and is issued with SGM credits commensurate with the emissions reductions achieved. The credits can then be sold.

A BCA aligned with the current framework could exacerbate these disparities by accounting for Scope 1 emissions only, and potentially giving imported electricity-intensive manufactured products an advantage by being unaccountable for their Scope 2 emissions. This could create a situation where domestic facilities using similar technologies face disproportionate liabilities under the SGM.

For example, glass manufacturing is a very energy-intensive process that is exposed to import leakage and can significantly benefit from electrification. Electrifying glass-melting furnaces using technologies such as electric resistance heating can significantly reduce Scope 1 emissions from combustion. However, if glass imports produced with this technology are sourced from locations with high scope 2 emissions e.g. where they are heavily reliant on coal for power generation, then a BCA could serve to shift Scope 1 emissions in Australia to Scope 2 emissions in the importing country.

**All domestic subsidies must be fully accounted for in the BCA carbon price** | Subsidies such as those provided under the Renewable Energy Target (RET) and the Capacity Investment Scheme (CIS) clearly serve to reduce both the carbon intensity of Australia's electricity sector and the effective carbon price faced by the power sector. Further, they are also likely to reduce the effective carbon price faced by electricity-intensive industries more broadly. Factoring these benefits into any future carbon cost to be applied to imports could result in very different estimates to the assumed proxy of a projected spot price for ACCUs.

To ensure the BCA operates equitably and efficiently the value of all emission reducing subsidies, implicit or explicit, should be deducted from BCA carbon pricing calculations. This approach would help prevent double counting of the associated abatement and reduce any likelihood of future claims that trade is being distorted and imports unfairly penalised under a BCA. This could plausibly lead to trade disputes under World Trade Organization (WTO) rules.

**A fee-based compliance approach is preferred to ensure sufficient ACCUs for SGM compliance** | An important consideration is the impact of higher demand for ACCUs if importers are allowed to fulfil BCA liabilities through the purchase and acquittal of ACCUs. Any additional demand for ACCUs could quickly exhaust any expected shortfalls in future ACCU supply and increase SGM compliance costs. This is especially true for facilities not covered by the BCA, including export-competing facilities like gas production, where their international competitiveness could be negatively impacted. While facilities are unable to access to high integrity international units for compliance under the SGM, a fee-based compliance process will be important. A fee-based approach can easily link to proxy carbon costs such as ACCU spot price, SGM credits and/or default unit price, to provide equivalence, as well as to generate general revenues to underwrite program implementation or further emissions reductions initiatives.

*Implementation of a Border Carbon Adjustment mechanism needs to be explored further; should implementation proceed it should be gradually to allow for an understanding of its real-world impacts*

**The design and implementation of a BCA needs to be explored further** | A BCA can, if designed and implemented well, help address transitional disparities created by uneven carbon pricing regimes across international jurisdictions. Its design must respect the Paris Agreement's explicit right of all nations, and especially developing nations, to self-determine their own pathways to net zero depending on their national circumstances (i.e., resources, competencies and capabilities) aligned with the UNFCCC's primary principle of Common but Differentiated Responsibilities (CBDR).

However, a BCA can only address the symptoms of uneven climate policy regimes rather than fix the root cause of a lack of globally harmonised carbon pricing regimes. Carbon pricing is integral to the design of a BCA as it establishes the foundation for assessing the differential carbon costs embedded in imported goods. Enabling a more 'level playing field' for domestic industries depends on a BCA adopting an accurate carbon cost.

**Design and implementation of a BCA should not be rushed, with consideration given to a phased implementation starting with high-risk commodities (e.g. cement).** Given the review's economic analysis indicating minimal national economic impacts on GDP and emissions with and without a BCA, there is little identified need to rush its implementation. We consider it worthy the government continue to explore the relative merits of a BCA in the SGM's 2026-27 review where it is already included in any future terms or reference.

A phased implementation of a BCA would allow for adjustments based on real-economy outcomes. It is agreed that initially targeting high-risk import-competing commodities like cement, with relatively straight forward supply chains, could help refine the framework before expanding it to other trade-exposed industries, like steel and advanced manufacturing that have more complex supply chains. A gradual approach would help minimise economic and trade disruptions while building capacity for more effective emissions monitoring across very complex supply chains.