Economic consequences of an ETS

The emissions trading scheme foreshadowed in the Government's recent Green Paper will be the single biggest regulatory change in Australia since the introduction of the GST. And like the GST, the lead-up to it is being accompanied by hype, misunderstanding and even fear – aided by the fact that, with less than 18 months to go till its scheduled introduction in 2010, many crucial details of the scheme remain vague. Even the Government's 'preferred positions', as identified in the Green Paper, will almost inevitably change in response to lobbying and the political compromises required to enact the relevant legislation.

Not the least of these crucial but unknown details is the *cost* of the proposed scheme, both in total and to individual companies and households. The initial price of the carbon pollution permits to be issued is key to the scheme's likely costs but also to its likely effectiveness, since creating a price signal that will actually change our carbon consumption is the primary objective of the whole undertaking. In addition, the likely effects of offsetting compensation to households and businesses will remain unclear at least until the release of Treasury's modelling in October – well after the due date for submissions on the Green Paper.

The resulting information vacuum obliges interested parties to estimate the costs and impacts of the scheme for themselves. The Green Paper's indicative initial carbon price of $20 per tonne of CO_2 emissions has become the base-case price for debate. Since the carbon price signal being placed on petrol is to be effectively 'switched off' by an offsetting fuel excise reduction for at least three years, virtually all of the cost signal will manifest itself to households through energy prices. The Green Paper suggests electricity prices will initially rise by 16% and gas and other household fuels by 9% as a result of the scheme, representing a total cost increase of 0.8% to 1.2% for households.

To put this price rise into perspective, national average retail electricity prices increased by 16.7% over the past three years, largely due to drought-related and commodity-based cost increases for electricity generators. While this price rise sounds large, utilities take only 2% of aggregate household expenditure in Australia (down from 2.5% 30 years ago). This time around, the Government proposes to compensate households in the lower to middle income ranges for the price rise. In conjunction with the fuel excise tax offsets, the actual net cost to households is therefore likely to be small. The all-important price signal on electricity should remain intact however, provided the compensation is paid in a general way (rather than as power bill subsidies or similar) and provided the full price signal is allowed to flow through to the retail level, rather than being neutralised along the way, as will be the case for petrol.

For businesses, only an estimated 1,000 companies in energy, transport, waste and heavy industry will be required to buy carbon pollution permits and participate in the scheme directly. For them, the costs are potentially large. At $20 per tonne, the cost of buying permits for all of their roughly 446 megatonnes of CO_2 emissions in 2006 would be just under $9bn. All other businesses will feel the effects of the scheme in the same manner as households — through higher energy and (eventually) transport prices. For all energy-intensive businesses however, the current uncertainty about future carbon costs, timing and compensation is also creating a real cost now, in the form of delays to investment decision-making, strategy and planning. As always with such grand schemes, the devil will be in the detail. But right now, there is also a devil in the lack of it.

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