ISSUEANALYSIS

A Waste of Energy: Why The Clean Energy Finance Corporation is redundant

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Now that the Gillard government has managed to get its climate change legislation through Parliament (and notwithstanding the possibility of a future government reversing reverse some of the policies), Australia is heading towards an environment in which CO_2 emissions will be priced in some form—first by carbon taxes until 2013 and then an emissions trading scheme starting in 2015.

As part of its climate policy, the government announced to establish the Clean Energy Finance Corporation (CEFC). This financial institution is meant to facilitate investment in clean energy technologies. To do so, it will receive $10 billion from the government to finance clean energy projects. At the same time, it is meant to be a profitable institution without competing with private investors. These contradictions are impossible to reconcile.

However, the most serious problem about the CEFC is its place within the framework of the government's climate change policy. Once Australia moves on to an emissions trading scheme, any cuts in CO_2 emissions will not result in an overall lowering of emissions but only in reducing the price of pollution certificates. In other words, emissions trading will cancel out any positive effects of the CEFC.

For these reasons—the lack of a clear mandate and the non-existent emissions effects—the CEFC should be scrapped.

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Introduction

As part of its policies to tackle climate change, the federal government announced in 2011 its proposal to establish the Clean Energy Finance Corporation (CEFC). The corporation is meant to facilitate investment in technologies with the potential to generate energy in an environmentally friendly way and will be funded by the federal government to the tune of $10 billion, starting with annual contributions of $2 billion out of the budget from 2013–14.[1] An expert review is inviting submissions on the design of the CEFC and will report to the government by March 2012. Following this review, legislation to establish the CEFC will be introduced in Parliament with the goal of creating the CEFC by 2013–14.

The establishment of the CEFC is a questionable political venture for a number of reasons. The very nature of the corporation is unclear: Is it a grant-giving institution or a commercially operating capital provider or both? This inconclusive dual nature, which is implicit in the government's plans, will make it virtually impossible to evaluate the success or failure of the CEFC. If it is meant to foster clean energies, its success would be measured by the number of projects it successfully completes. If it is meant to be a commercially oriented capital provider, it would be judged on its return on investment. Both objectives are difficult to achieve simultaneously. In fact, they would most likely cancel each other out. This makes the dual mandate of achieving energy results and being commercially viable an insurmountable contradiction.

The CEFC does not fit into the government's general policy direction towards an emissions trading scheme.

Under CEFC, investment risks, which ought to be borne by private entrepreneurs, are relegated to taxpayers. Private capital providers are outcompeted by cheaper finance made available through the CEFC. The distortions for capital markets are plain to see.

Even worse, however, is that the CEFC does not fit into the government's general policy direction towards an emissions trading scheme. Once Australia's climate change policy has moved to a cap-and-trade scheme, there will no longer be a need for any alternative climate change policies. By its very nature, an emissions trading scheme replaces other policy initiatives and renders them ineffective. To continue with them regardless imposes costs on Australian taxpayers without achieving any additional environmental benefits.

The billions of dollars that are set to flow into this most dubious political entity are likely to be a complete waste of money as well as a distortion of capital markets. This Issue Analysis outlines the basic problems with the CEFC and reasons why it should not be established at all.

A contradictory mandate

The overall goal of the government's climate change policy is to cut the total amount of greenhouse gas emissions by moving away from fossil fuels to other sources of energy.

To facilitate Australia's transition from an emissions intensive to a low emissions economy, the government announced in October 2011 its proposal to establish the Clean Energy Finance Corporation as part of its climate change policy:

> The Government announced the CEFC as part of the Clean Energy Future package in order to encourage private investment and help overcome capital market barriers to commercialising clean energy technologies. The CEFC will also invest in firms utilising these technologies as well as manufacturing businesses which focus on producing inputs to these technologies.[2]

This sounds like a government scheme to assist potential investors in developing new technologies by giving funding on terms that would not be available to them in capital markets. If that were the case, the CEFC would effectively provide subsidies. It would also have to 'pick winners,' i.e. decide which technological projects would be worth subsidising.

The government is keen to avoid such an impression—probably because it sounds too much like old-fashioned industrial policy—and has reiterated in its statements that the CEFC is not a conduit to pay capital subsidies to investors. For example, in its request for submissions to an expert review of the CEFC, the government says:

> The CEFC will not provide grants. It is intended to be commercially oriented and to make a positive return on its investments.[3]

But the government immediately contradicts itself in its own clarification:

> The CEFC is not intended to compete directly with the private sector in the provision of financing to the clean energy sector; instead, it is intended that the CEFC will act as a catalyst to private investment that is currently not available for clean energy technologies.

When the government argues that the CEFC will not provide grants, it probably means that it will not pay out subsidies. To insist at the same time that the CEFC will not compete with the private sector despite supposedly being commercially oriented (i.e. seeking to deliver a return on investment) makes the earlier claim sound spurious. Either the CEFC will be a commercial entity that develops technologies with taxpayer money and competes with the private sector, or it will be a non-commercial body that funnels subsidies to private enterprises.

So the government is establishing a publicly funded institution, tasked with achieving government mandated goals but calls it a commercial venture. However, there can be no squaring of the circle when it comes to the nature of a financial corporation like the CEFC. It can be commercial or non-commercial but not both at the same time.

This contradictory mandate of the CEFC is further complicated by its ambiguous aims, leaving the agency unaccountable:

> The objective of the CEFC is to overcome capital market barriers that hinder the financing, commercialisation and deployment of renewable energy, energy efficiency and low emissions technologies.

> The CEFC will invest in firms and projects utilising these technologies as well as manufacturing businesses that focus on producing the inputs required. It will not invest in carbon capture and storage technologies.

There can be no squaring of the circle when it comes to the nature of a financial corporation like the CEFC.

From these statements it is only clear what the CEFC will *not* do, not what it will do. It will not invest in capture and storage. Beyond this exclusion, it could initiate a range of clean energy initiatives such as research and development on energy saving products and energy generation or distribution. It could equally apply to the utilisation of existing technologies instead of just new technologies.

The economic viability of projects based on existing technologies can be easily assessed by studying existing installations, either in Australia or abroad. If such projects are economically viable, there should be no lack of private capital to finance them, so there should be no reason for the CEFC to invest in them. On the other hand, if existing technologies do not generate a sufficient return on investment, should the CEFC invest in commercial ventures that have already proved to be a failure?

As for new technologies, it is even more difficult to justify the CEFC's mandate. It is for the investors and not the CEFC to ask whether new technologies will work, and if they do, whether they will be economically viable. In answering these questions, investors have to be willing to accept the risk that they may be wrong. And they can be wrong in two ways: They can decline funding for projects that turn out to be profitable and they can fund projects that fail to generate the expected return on investment.

Investment decisions, particularly in new technologies, are entrepreneurial decisions. They require an entrepreneur as a capital provider who is willing to bear risks. The CEFC is no such entrepreneur-investor. It is a government instituted and funded organisation with a mandate to hand over losses to the taxpayer. Taxpayers, unlike private investors, tend to be less vocal about poor returns simply because their individual exposure is limited. What this means for investment decisions of a corporation like the CEFC is that it can escape the scrutiny that shareholders would exert.

With such little or no accountability, it would be easy for the CEFC board to engage in risky investments that may also be politically desirable. Political considerations will definitely play a role in the CEFS's investment decisions since it has already ruled out 'carbon capture and storage' as a potential investment opportunity. So the board of the CEFC could not invest in a superbly profitable capture and storage project even if it wanted to for political reasons, but it could invest in an unprofitable but politically desirable project with taxpayers' money because the CEFC is not accountable to the public.

Investment decisions, particularly in new technologies, are entrepreneurial decisions.

In essence, this means the CEFC will be picking winners, which contradicts the stated objective of the CEFC operating as a commercial venture. Moreover, this lack of a clear mandate will make it difficult in the future to evaluate the CEFC's performance. If it makes a splendid return on investment, then why was the involvement of a taxpayer backed entity necessary in the first place? If it does not generate large profits, the CEFC will look like a traditional slush fund out of which politically desirable, commercially unprofitable projects are financed.

Either way, the CEFC cannot win. It will by its very nature remain a compromised institution.

No place for a CEFC within an emissions trading scheme framework

The CEFC is expected to start operations in 2013–14. This means that only for the first two years will the CEFC operate in an environment without an emissions trading scheme. From 2015, the carbon tax will be replaced by a cap-and-trade scheme for greenhouse gases. This also means that from 2015, there will be no need for the CEFC.

There are two basic options to any emissions abatement policy. The first is to reduce emissions indirectly by investing in new technologies, taxing energy use, issuing targets for renewable energies, etc. The common theme in all these measures is that they aim to drive down the total amount of emissions without actually putting a hard, enforceable limit on them. This way, the total emissions are a result of government policies but not by government policies.

The second option is a cap-and-trade emissions trading scheme in which government decides the total amount of emissions and lets the market decide how to achieve a mandated emissions reduction by trading pollution rights. There would be no need for any government action under an emissions trading scheme. In fact, further action would be futile as it would not have any effect on emissions beyond the mandated target. The total amount of emissions is already determined by the emissions trading scheme.

Suppose an economy emits 1,000 units of pollution and an emissions trading scheme issues certificates for 900 units of pollution. Polluters will themselves have to find ways to cut back their emissions by 100 units. Depending on the avoidance costs, the right to pollute would be priced in the market. The cheapest ways to cut pollution would be implemented first, and so the market would decide on the best way of cutting 100 units of pollution from the previous pollution level of 1,000 units.

If government intervened directly and paid some polluters to introduce technological improvements to reduce their individual pollution, it would result in a lower price for the pollution certificates, but the total amount of emissions would remain at 900 units. In other words, government's extra investment would have a zero effect on emission levels.

The flaw in combining cap-and-trade schemes with further emissions reducing measures is so obvious that it is hard to imagine governments would make such illogical mistakes in the design of their policies. Yet it has happened in other countries, and with the CEFC, Australia is about to commit the same mistake.

The problems with the combination of cap-and-trade schemes with other emissions cutting measures became apparent almost a decade ago in Europe where a CO_2 emissions trading scheme was introduced without winding back other forms of subsidies for renewable energies. This led the academic advisory council to the German economics ministry to issue a unanimous call for the abolition of the *German Renewable Energies Act*, a law that provided for implicit subsidies mainly for wind and solar power generation. The German government's experts concluded that this law, despite imposing enormous costs on businesses and consumers, would yield a zero effect on emissions because of the simultaneous presence of the European emissions trading scheme.[4] The German government's Monopoly Commission, the German equivalent of Australia's Productivity Commission, recently came to the same conclusion in a special inquiry.[5] In the same way, the CEFC will have zero effect on emissions once the emissions trading scheme is fully implemented.

Governments wishing to cut emissions would have to choose which path they want to follow: ration the total amount of emissions via an emissions trading scheme or lower emissions using industrial policy. In practice, politicians will always try to do both simultaneously. This way they can claim to be a) using market mechanisms (which sounds nicer than the old-fashioned and discredited 'picking winners' policies, and b) support concrete projects for which they can claim credit.

From a public choice perspective, an emissions trading scheme is not an attractive choice for politicians. Emissions that are cut through a largely invisible trading process are not easy to sell as a political achievement directly attributable to an individual politician or a party. However, funnelling finance for concrete projects offers ample opportunities for politicians to appear at construction sites wearing hard hats and safety vests. Perhaps this is a more plausible explanation for politicians' willingness to fund these initiatives even in an emissions trading scheme environment. At least there is no better explanation because from a rational, disinterested perspective, there are no justifications to pursue policies that have no net benefit but only costs.

The government's extra investment would have a zero effect on emission levels.

Conclusion

Very few topics in Australia have been as fiercely debated as climate change and the political response to it. The issue has dominated politics for years.

Now that the Gillard government has managed to get its climate change legislation through Parliament (and notwithstanding the possibility of a future government reversing some of the policies), Australia is heading towards pricing CO_2 emissions in some form.

With the basic climate change legislation in place, the question is whether individual measures in a carbon pricing and trading environment are effective and efficient. Individual measures on climate change policy need to be evaluated according to their compatibility with the government's general framework. Greenhouse gas reductions can be achieved in different ways but policies should be compatible, not cancel each other out. Unfortunately, the latter is happening with respect to one of the core projects in the government's clean energy legislation.

Considering the severe problems regarding the CEFC's mandate and its place within the government's climate change policies, the plan to establish the CEFC should be abandoned. The money supposed to be spent on the CEFC would be better spent elsewhere—or even better not spent at all.

Endnotes

1 Australian Financial Centre Taskforce Secretariat, 'Mid-Year Economic and Fiscal Outlook,' Appendix A: Policy Decisions Taken Since the 2011–12 Budget, Expense Measures (Canberra: Treasury).
2 Joint media release by Treasurer Wayne Swan and Climate Change Minister Greg Combet (12 October 2011).
3 Request for submissions to the Expert Review of the Clean Energy Finance Corporation.
4 Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft und Arbeit, *Gutachten zur Förderung erneuerbarer Energien* (Berlin: 2004).
5 Monopolkommission, Energie 2011: *Wettbewerbsentwicklung mit Licht und Schatten* (Bonn: 2011).

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