

Questions and Answers About Australia's Future Emissions Trading Scheme

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In response to the many questions that have been raised about Australia's plans to introduce a formal emissions trading scheme, this paper provides our answers to the most frequent questions.

1. What is an emissions trading scheme (ETS)?

An ETS is a formal, regulated market that facilitates the buying and selling of carbon credits, that is, a "carbon market".

2. What exactly are carbon credits?

Carbon credits represent the benefit to the global environment from a reduction of greenhouse gas (GHG) emissions. When traded in a carbon market, carbon credits reflect the market value of a unit allowance to emit GHGs. They are measured in carbon-dioxide equivalent (CO₂-e) units.

Under the Australian ETS, carbon credits will be called "permits".

3. Is Australia implementing its own ETS? If so, when?

Yes. The design of the Australian ETS will be finalised by the end of 2008, with trading to commence in 2010.

4. Why is Australia implementing an ETS?

The Australian Government ratified the Kyoto Protocol in early December 2007, committing Australia to capping its GHG emissions. The ETS will be Australia's principal strategy to meet its Kyoto target.

5. How will the ETS work?

The Australian ETS will be a 'cap-and-trade' system like that of the EU.

Cap-and-trade systems limit the total emissions of the economy and create a market to enable firms to determine where it is most cost-effective to meet emission reductions.

The cap will be created, first, by making it illegal to emit GHGs above a certain level and, secondly, by issuing a limited quantity of emission permits. The buying and selling of spare permits creates the "carbon market".

At the end of each year, firms will be required to surrender permits equivalent to their emissions. A shortage of permits will attract a penalty.

6. How can firms keep within the law?

Firms will be able to meet their emissions targets by:

- (a) investing in more efficient technology;
- (b) using less emissions-intensive energy sources;
- (c) investing in abatement schemes, including sinks and offsets; or
- (d) purchasing permits at the auctions or in the secondary market.

These choices are likely to be informed by relative costs, resulting in the reduction of emissions wherever it is most cost-effective in the economy.

7. How will permits be allocated?

There are a variety of different approaches to permit allocation. They can be sold at a fixed price, allocated for free, sold at auction, or distributed by a mixture of these approaches.

It is most likely that the Government will implement a *compensatory approach* of permit allocation. This is expected to involve:

- (a) allocation of free permits to compensate for disproportionately affected industries, and
- (b) progressive auctions of the remaining permits to all participants.

How, and to what degree, industries and firms will be treated cannot be judged until the allocation approach is decided by the Government.

8. Who is likely to get the free permits?

The free permits are likely to go to (1) firms that suffer disproportionate loss to the economy-wide average and (2) firms that are engaged in trade-exposed, emissions-intensive industries.

Eligibility will depend on the aggregate of direct and indirect, post-tax emission costs impacting on firms. In this regard:

- (a) the direct costs could be estimated according to averages of emission intensities or the costs associated, benchmarked against best-practice low emissions technology; and
- (b) the indirect costs could be estimated by economic modelling of the cost increases embedded in production and distribution inputs.

It is possible that the allocation of free permits will only be made on a once-off basis.

9. What will the auctions involve?

The auction is the method by which the Government will sell permits to individual firms. At this stage the exact process is yet to be delineated.

The Government aims to create an efficient market that is liquid, where prices are transparent.

Regular, large-scale auctions are expected during the first decade of the ETS, followed by smaller, less frequent auctions after 2020.

10. What will the Government do with the revenue from the auctions?

No-one knows. The Government could use this revenue to enter the market to stabilise prices. It could also provide incentives for low-emission technology R&D, and motivating industry take-up of more energy-efficient practices. Or it could subsidise firms or households that cannot afford the increased costs that carbon prices will bring.

11. Who will be affected by the ETS?

All firms are likely, either directly or indirectly, to be affected by increased costs. Some may be able to pass them on to their customers.

All consumers are likely to be affected to the extent that costs are passed through to them in the form of price increases.

12. How will individual firms be differently affected?

The effect on individual firms will depend on the firm's exposures. These will comprise direct exposures from its emissions and indirect exposures from the increased prices of inputs. The effect will be lessened by a firm's ability to pass on its increased costs to consumers.

Risks about the price of permits may induce some firms to invest in the financial derivatives market. Some might take advantage of the availability of carbon abatement schemes, energy saving technologies and practices, and linkable permits on the international market. These are all potential strategies for firms to keep within their carbon restrictions.

The effect on prices and consumer demand will be a priority concern for all businesses affected by the ETS.

13. What is the main risk for market participants?

Irrespective of what the legislation might call them, Australian emission permits will be a legislative artifice: created by legislation, defined by legislation, changeable by legislation and extinguishable by legislation. Certainly nothing like a commodity, nor anything like stocks or shares.

Permits will be environmental instruments. The Government will tend to encourage scarcity of supply and allow market demand to push the price up, but not so far (and not so fast) as to cause damage to the economy.

Carbon markets must be recognised as markets in regulatory risk that are uniquely vulnerable to arbitrary regulatory intervention.

14. How will emissions be monitored?

The *National Greenhouse and Energy Reporting Act 2007* ("the Reporting Act") has already established a national system for reporting of GHGs.

The Reporting Act requires firms to register, report and publish their emissions data. These requirements take effect at different stages over the next three years and apply according to whether firms or their controlled facilities reach certain thresholds in emissions.

The recording of emissions has been standardised by an online reporting system. This system stores data of the energy and materials used in industry. It automatically converts this data into GHG equivalent quantities. The Reporting Act requires totals of GHG emissions to be published.

15. What are carbon offsets?

Carbon offset schemes will be alternative means of obtaining emission permits. An ETS participant will be able to invest in ventures that verifiably reduce Australia's carbon emissions. Many of these reductions will be able to be converted into carbon credits. Examples include carbon sinks and agricultural activities.

Widespread investment in a variety of carbon offset schemes is already taking place. Interest in these schemes will increase exponentially in the lead-up to the commencement of trading in the ETS.

The unresolved question is which schemes will actually qualify for conversion into carbon credits under the ETS when it comes into force.

16. What are the rules regarding 'green' advertising?

Section 52 of the Australian *Trade Practices Act* 1974 applies to 'green' marketing claims concerning carbon neutrality and carbon offsets. The Australian Competition and Consumer Commissions (ACCC) requires advertisements to be clear, well substantiated and verifiable.

The ACCC is closely monitoring the veracity of 'green' claims in response to an increasing number of complaints from consumers. It has recently called for responses to an issues paper on this subject.

The ACCC is currently running a test case in the Federal Court of Australia alleging misleading and deceptive conduct arising from claims made about the carbon neutral credentials of Saab vehicles. Many similar cases can be anticipated.

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- our involvement in the informal domestic and cross-border markets that have developed over the last 10 years in anticipation of the widespread adoption of formal, regulated schemes.

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