

SPECIAL BULLETIN:

16 December 2008

A Preliminary Review of the White Paper on Australian Carbon Pollution Reduction Scheme (CPRS)

How We Got to the White Paper

In December 2007, the Australian Government ratified the Kyoto Protocol. This committed Australia to capping its GHG emissions although, like all parties, it remained entirely free to take whatever domestic action was necessary to honour its commitment. However, the Government had already made what it describes as a 'central election commitment' to take decisive domestic action on climate change.

On 15 December 2008, the Government issued a White Paper, honouring its election commitment but opting for a soft start of a 5% reduction in emissions below 2000 levels by 2020. The scheme will at least provide valuable lessons for Australia but will cause considerable disruption to the economy in what is a very difficult financial climate.

The 5% target is subject to increase of up to 15% *"where economies commit to substantially restrain emissions and all developed countries take on comparable reductions to that of Australia"*.

What We Predicted

The Government's central election commitment has now been subjected to a major reality check, as we predicted in a circular to our clients before the White Paper was issued:

"The Government has painted itself into a corner. It has been obvious from the Garnaut Report and from the Government's July Green Paper (which attracted over 1000 submissions) that the Government could not make any impact on the global level of carbon emissions. With Australia accounting for only 1.4% of global emissions, an Australian scheme cannot do anything for the climate, here or anywhere else in the world.

The UK Stern Review found that carbon pricing alone would never be sufficient to reduce emissions on the scale and at the pace required. That was when times were good. In the current financial climate, carbon pricing would be futile.

A trading scheme will only reduce emissions if it delivers punitively high carbon prices or prices that, if not punitive, are high enough to induce emitters to change their practices.

A 'soft start' will not get Australia anywhere and a 'hard start' is inconceivable in the current financial climate. Even then, if other countries don't make the same move, a trading scheme exercise is futile for a country like Australia once you understand that this is a global problem.

The worst consequence of the scheme will be the disruption and cost that Australia's trade-exposed industry sectors will be exposed to. Much of this could have been avoided if the Government had not painted itself into a corner before it was necessary".

As we explain on page 5 of this special bulletin, the scheme is now only one of four overlapping elements of the Government's emissions reduction strategy.

Scheme Caps and Gateways

The central element of the scheme will be the annual 'caps' (that is, emissions limits). These caps will be set for the first 5 years and will be extended each year by one year to maintain a constant 5 year horizon. The first 5 years of caps will not be announced until 2010, after the Copenhagen meeting of the UNFCCC.

The Government will also set 'gateways' or ranges within which future caps will be set for 10 years beyond the preceding caps. The gateways will be reviewed every 5 years.

Permits

Permits will be auctioned to all emitters that are covered by the scheme (unless firms qualify for free permits – as to which, see below).

Permits will have a 'vintage', the earliest year they can be used, but without an expiry date. This will allow permits to be banked indefinitely.

Firms will have a small borrowing allowance – using the following year's permits for up to 5% of their current year's liabilities.

Permits will constitute personal property that cannot be extinguished without compensation (unless there has been misrepresentation or fraud).

International Linkages

Permits may not be exported. This is to reduce the upside price risk.

Firms will however be able to use Kyoto units for compliance with scheme obligations. There will be no limits on this right which will provide a potential safety valve on compliance costs.

Scheme Coverage

The CPRS will apply to all large emitters (those who emit in excess of 25,000 tonnes per annum) in nearly all industry sectors. This will directly affect around 1000 firms and is likely to catch 75% of Australia's total emissions.

The main unaffected sector is agriculture. This will not be included for another 5 years due to the difficulty of measuring emissions from the wide range of different agricultural activities.

Similarly, offset credits are unlikely to be included for another 5 years.

Mechanics of the Scheme

The quantity of emissions produced by firms will need to be monitored, reported and audited.

Emitters will need to acquire a permit for every tonne of greenhouse gas that they emit.

At the end of each year, each liable entity will need to surrender a permit for every tonne of emissions that they produced in that year.

Firms will compete to purchase the number of permits that they require. Firms that value the permits most highly will be prepared to pay most for them, either at auction or on a secondary trading market. For some firms, it will be cheaper to reduce emissions than to buy permits.

Certain categories of firms will receive an administrative allocation of permits, as a transitional assistance measure. Those firms could use the permits or sell them.

What Will Be the Price of Permits?

The price of permits will be capped at A\$40 for the first 5 years, rising at 5% per annum.

Below the cap, no-one can predict the market price with certainty. It will be determined by supply and demand.

Treasury modelling suggests that the permit price may be around A\$23 at the time of scheme commencement.

If a price of A\$23 is assumed, the cost for a low-level emitter that emits 25,000 tonnes per annum would be A\$575,000 per annum.

Impact of the CPRS on Firms

Each firm in the Australian economy will be impacted by:

- (i) the direct costs that are incurred in relation to its own emissions and
- (ii) the indirect costs from the increased prices of its production inputs (such as higher-priced electricity).

This impact will be lessened to the extent that firms are able to pass on their increased costs to consumers.

Electricity Sector Adjustment Scheme

There will be a special electricity sector adjustment scheme for a period of 5 years to soften the impact of the scheme on the most emissions-intensive coal-fired electricity generators. Only those generators experiencing significantly adverse effects will be eligible.

EITE Assistance Program

Emissions-intensive, trade-exposed (EITE) industries, such as LNG and metal producers, may be unable to pass on their increased costs to customers because of competition from exporters in other countries that do not impose an emissions penalty.

The inclusion of EITE industries in the scheme will to some extent diminish the international competitiveness of many existing investments and scare off new investments in these industry sectors.

The Government will provide transitional assistance to EITE industries by allocating around 25% of the total scheme permits for free. The key features of the program are summarised in the table below:

Feature	Policy
Form of assistance	Allocation of permits at the start of each compliance period Based on individual entity's previous year's level of production Upon closure, must relinquish permits for production that did not occur in that year
Basis of assistance	Provided to new and existing entities undertaking an eligible EITE activity prescribed in regulations
Scope of assistance	Direct emissions covered by the Scheme Scheme related cost increase for electricity and steam use

	Scheme related cost increase for upstream emissions from natural gas and its components (e.g. methane and ethane) used as feedstock
Eligibility for assistance	<p>Eligibility of activity based on an assessment of all entities conducting an activity</p> <p>Trade exposure assessed through quantitative and qualitative tests</p> <p>Emissions intensity assessment based on average emissions per million dollars of revenue or emissions per million dollars of valued added</p> <p>Time period for assessment: emissions data: 2006-07 to 2007-08 revenue/value added data: 2004-05 to the first half of 2008-09</p>
Initial rates of assistance	<p>90% for activities with emissions intensity of at least 2000t CO₂-e/\$m revenue or 6000t CO₂-e/\$m value-added</p> <p>60% for activities with emissions intensity between 1000t CO₂-e/\$m and 1999t CO₂-e/\$m revenue or between 3000t and 5999t CO₂-e/\$m value-added</p>
Carbon productivity contribution	Initial rates of assistance will be reduced by a carbon productivity contribution of 1.3% per annum
Allocative baselines	<p>Allocative baseline for activity based on historic industry average level of emissions per unit of production for all entities conducting activity</p> <p>Electricity allocation factor set at 1t CO₂-e per MWh nationwide, may be adjusted in respect of existing large electricity supply contracts</p> <p>Natural gas feedstock allocation factor set state by state</p>
New entrants	<p>New entities conducting an existing EITE activity will receive the same assistance as existing entities conducting the activity</p> <p>Activities new to Australia will be able to apply for EITE eligibility -- assessment and baselines made on the basis of international best practice</p> <p>Allocations to existing entities conducting EITE activities will not be adjusted for allocations to new entrants</p>
Quantum of assistance	Government expects allocations to EITE sector to be around 25% initially (35% including agriculture), increasing to around 45% by 2020
Review of assistance	<p>EITE assistance program to be reviewed by independent body at each five year review point, or at request of Minister</p> <p>Review would consider:</p> <p>inclusion of additional activities in light of commodity price changes and expansions in Scheme coverage</p> <p>consistency of EITE program with overall rationale and principles</p> <p>existence of broadly comparable carbon constraints applying internationally</p> <p>Five years' notice of any changes to EITE program to be provided, unless required for compliance with Australia's international trade obligations</p>

LNG exporters are treated relatively unfairly since no recognition is given by the scheme to the emissions that are reduced abroad by the displacement of coal as a fuel in electricity generation.

How to Meet the Emissions Targets

Liable firms will be able to meet their emissions targets in 5 main ways:

- (i) by purchasing permits, either at the auctions or in the secondary market;
- (ii) by using less emissions-intensive energy sources;
- (iii) by switching to more efficient production technology;
- (iv) by cutting back production; or
- (v) by investing in abatement schemes.

Examples of abatement schemes are forestry projects in Australia and the various types of Clean Development Mechanism (CDM) projects in developing countries.

Climate Change Action Fund

The Government will establish a \$2.15 billion Climate Change Action Fund to be expended over five years to smooth the transition for businesses, community sector organisations, workers, regions and communities to an operating environment that includes a price on carbon.

Complementary Measures

One of the most telling aspects of the White Paper is almost hidden away in chapter 19 on Complementary Measures. There the truth is revealed: that, as the Stern Review found, a trading scheme will not actually be effective in inducing the switch to low-emissions technologies on the scale and at the pace required. To the extent that this is so, much of the rationale for the scheme falls away and the Emperor loses most of his clothes, especially when the scheme is based on a 'soft start'!

According to chapter 19:

"The Government's emissions reduction strategy has four foundation elements: the Carbon Pollution Reduction Scheme, the Renewable Energy Target, carbon capture and storage, and energy efficiency. The latter three of these focus on reducing emissions from stationary energy sources, which emit the largest proportion of Australia's greenhouse gases and have the greatest potential for transformation."

(i) Renewable Energy Target

The aim of the Renewable Energy Target is to ensure that 20% of electricity is generated from renewable sources by 2020. According to chapter 19, *"The measure will help ensure that renewable energy technologies can be readily deployed when the price signal under the Scheme makes those technologies more competitive."*

(ii) Carbon Capture and Storage (CCS)

CCS is another foundation element of the Government's emission reduction strategy.

According to chapter 19:

"The Garnaut Climate Change Review observed that the greatest barriers to innovation is CCS technologies are cost and commercialisation of technology to the scale required. CCS will need to overcome a barrier common to new technologies: early movers might face higher costs than later adopters of the technology and might not reap the full benefits of their investment."

The Government is therefore supporting ways to scale up and deploy CCS technology across the world.

(iii) Energy Efficiency

According to chapter 19:

"While the introduction of the Scheme will drive improvements in energy efficiency by creating a price signal that encourages the use of less energy, in the short term a number of market failures are likely to persist, impeding investment in energy efficiency by households and business."

Voluntary Carbon Offsets

The Government will develop a national standard for carbon offsets to provide national consistency and give consumers confidence in the voluntary carbon offset market. A discussion paper on the national standard is to be released shortly.

Timeline for Introduction of Scheme

1 st Quarter 2009:	Release of guidance paper on data requirements of the emissions-intensive trade-exposed (EITE) assistance program Entities engaged in EITE activities submit data <i>Late February:</i> Draft legislation released
2 nd Quarter 2009:	<i>Early April:</i> End of consultation period on draft legislation <i>May:</i> Legislation introduced into parliament <i>June:</i> Draft regulations released
3 rd Quarter 2009:	Legislation in force Regulator established Private entities able to open registry accounts for Kyoto units
4 th Quarter 2009:	Stage 1 regulations issued UN Climate Change Conference, Copenhagen
1 st Quarter 2010:	Government announces: <ul style="list-style-type: none">➤ extension of indicative national emissions trajectory up to 2014-15➤ scheme caps for first five years of scheme (2010-11 to 2014-15)➤ up to 10 years of scheme gateways after 2014-15 National registry becomes operational Stage 2 regulations issued
1 st to 2 nd Quarter 2010:	First auction of permits
3 rd Quarter 2010:	<i>1st July:</i> Start of first compliance year

Reporting of Emissions Data

The *National Greenhouse and Energy Reporting Act 2007* is already in force. It requires all major emitters to register and report their emissions data in advance of the start-up of the CPRS.

Further Information

This preliminary review is neither comprehensive nor complete. Our managing director Robert Pritchard can be contacted for further information at robert@resourceslaw.net.

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