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### An Overview of the proposed Australian Carbon Pollution Reduction Scheme

*On 16 July the Australian government released its Carbon Pollution Reduction Scheme Green Paper. The greenhouse gas emissions trading scheme proposed in that paper will represent a considerable opportunity for the Australian banking and financial services sector, which could previously only watch carbon trading developments in Europe or participate in the various local voluntarily or State-based incentives. Despite press coverage to the effect that Australia's proposed emissions trading scheme is "half baked", emissions trading in Australia has been the subject of a protracted and complex policy debate. The Green Paper now presented adopts many of the hallmarks of the emissions trading scheme designs developed in earlier policy proposals, while some of the proposed mechanics represent a complete departure from the previous policy direction (including proposals that were not raised by the Government-commissioned Garnaut Review). This paper briefly reviews the history of policy development and turns to consider some key elements of the Green Paper proposal.*

#### Development of an Australian emissions trading scheme

Although popular interest in the consequences of an Australian emissions trading scheme has only found its way into local Australian media in the last few months, the policy development of emissions trading in Australia has a much longer history. New South Wales had one of the first mandatory greenhouse gas emissions trading schemes in the world. That emissions trading scheme, the New South Wales and Australian Capital Territory Greenhouse Gas Abatement Scheme<sup>81</sup> ("**GGAS**"), commenced on 1 January 2003 in New South Wales and is still operating. The scheme was politically palatable at the time because the liability was imposed primarily on electricity retailers, the greatest market share of which in New South Wales is held by State-owned corporations. The scheme does not operate like a "cap and trade" scheme, of the type now proposed in the Commonwealth Government's *Carbon Pollution Reduction Scheme Green Paper*<sup>82</sup> ("**Green Paper**"), but rather each of the liable electricity retailers (and certain other liable parties) are deemed to have caused a volume of emissions based on the electricity that they buy<sup>83</sup> and are allocated a benchmark or targeted level of emissions based on the electricity that they sell as a proportion of the total demand for electricity in the State<sup>84</sup>.

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<sup>81</sup> *Electricity Supply Act 1993* (NSW) ("**ES Act**") part 8A

<sup>82</sup> Department of Climate Change, *Carbon Pollution Reduction Scheme Green Paper*, July 2008, Commonwealth of Australia ("**Green Paper**")

<sup>83</sup> *Greenhouse Gas Benchmark Rule (Compliance) No. 1 of 2003* ("**Compliance Rule**"), equation 2

<sup>84</sup> *Compliance Rule*, equation 3

Effectively, based on the relative contributions of these liable parties to emissions from the electricity sector in New South Wales and a targeted cap on emissions in that sector<sup>85</sup>, the liable parties are required to offset part of their deemed emissions to achieve their individual benchmarks and so the required cap across the sector. The required offsets are recognised in the form of "New South Wales Greenhouse Abatement Certificates" (known as "NGACs") which are tradable<sup>86</sup> and can be created by accredited persons<sup>87</sup> from certain eligible activities that are considered to contribute to reducing emissions<sup>88</sup>. Large electricity consumers are entitled to elect to take on this deemed greenhouse gas emissions liability<sup>89</sup>, with a view to managing the required offset of emissions more effectively than their electricity retailer might have otherwise. Such large users are also entitled to be recognised for another form of offset from certain accepted reductions in process-related greenhouse gas emissions not connected with the consumption of electricity<sup>90</sup> (by creating non-tradable Large User Abatement Certificates or "LUACs").

New South Wales implemented this scheme at a time when Australia's Federal Government had refused to ratify the Kyoto Protocol and was refusing to implement a consistent national emissions trading scheme. The scheme was soon adopted by the Australian Capital Territory<sup>91</sup>. Other States chose not to implement the scheme, which was possibly the political reality of some States having privatised the retail electricity sector and other States considering that the impact on industry, in terms of the costs passed through the electricity market, could be too great. GGAS was also administratively complex because the benchmark and offset system required complex rules and processes to determine whether a particular project to reduce emissions could be recognised as an offset.

In the absence of Federal Government action, the Australian State and Territory Governments established a National Emissions Trading Taskforce ("NETT") in January 2004. Its terms of reference were to develop a scheme design for an inter-jurisdictional national emissions trading scheme that could be driven at the State and Territory level<sup>92</sup>. The NETT produced a discussion paper in August 2006 which proposed a "cap and trade" emissions trading scheme<sup>93</sup>. Under cap and trade schemes, the Government auctions or gives away tradable permits or allowances (each corresponding to 1 tonne of carbon dioxide equivalent emissions) up to the volume of the

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<sup>85</sup> ES Act ss 97B and 97BC

<sup>86</sup> ES Act part 8A division 6

<sup>87</sup> ES Act part 8A divisions 4 and 5

<sup>88</sup> ES Act ss 97DA(2)-(6)

<sup>89</sup> ES Act s 97BB(1)(d)

<sup>90</sup> ES Act s 97DA(3)(c) and *Greenhouse Gas Benchmark Rule (Large User) No. 1 of 2003*

<sup>91</sup> *Electricity (Greenhouse Gas Emissions) Act 2004 (ACT)*

<sup>92</sup> First Ministers of State and Territory Governments, *Terms Of Reference for the Inter-Jurisdictional Working Group On Emissions Trading*, January 2004

<sup>93</sup> National Emissions Trading Taskforce, *Possible Design for a National Greenhouse Gas Emissions Trading Scheme*, August 2006 ("**NETT Discussion Paper**")

intended cap on emissions. Entities that are covered by the scheme are liable to periodically surrender or bring to account a number of permits or allowances corresponding to the volume of greenhouse gases emitted during the relevant compliance period. Liable entities, if in shortfall of the required number of permits, are typically required to pay a penalty or fee and may also be required to make good any shortfall in following compliance periods (although the NETT proposed only a civil penalty in these circumstances). The broad design features of the scheme proposed by the NETT were similar to the scheme now proposed in the Federal Government's Green Paper. However, the scope of the scheme proposed would have only applied to electricity generators initially (with a capacity over 30 MWe) and would have extended to certain other stationary energy sources of greenhouse gas emissions over 25 ktCO<sub>2</sub>-e per annum (including deemed emissions from natural gas sales and fugitive emissions from gas pipelines) after the first 5 years of the scheme<sup>94</sup>.

In the face of public pressure, the former Prime Minister separately established the Prime Ministerial Task Group on Emissions Trading ("**Task Group**") in December 2006 with a similar objective to the NETT. Key to its terms of reference was a requirement that the scheme proposed should not affect Australia's international competitiveness and should have regard to Australia's competitive advantage from "large reserves of fossil fuels and uranium"<sup>95</sup>. The Task Group was comprised of a number of representatives from Australian business and industry, as well as Government representatives. To the surprise of Australian industry, and possibly to the surprise of the Prime Minister himself, the Task Group when it reported on 31 May 2007 recommended that Australia implement a "cap and trade" emissions trading scheme by 2011<sup>96</sup>. Significantly, the scope of the scheme proposed by the Task Group was broader than any emissions trading scheme proposed before in Australia. The scheme design encompassed liability for direct emitters meeting a 25 ktCO<sub>2</sub>-e per annum threshold not only in the stationary energy sector, but also proposed to impose upstream liability on fuel distributors for the downstream emissions associated with distributed energy consumption such as in relation to transport, industrial processes and off-grid diesel applications. The Task Group adopted, without acknowledgement, many of the proposals previously put forward by the NETT<sup>97</sup>, but in some cases expanded on the tests or mechanisms that could be used to implement the scheme<sup>98</sup>.

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<sup>94</sup> NETT Discussion Paper, pp 20 -23

<sup>95</sup> Prime Minister of Australia, *Task Group on Emissions Trading terms of reference*, 10 December 2006

<sup>96</sup> Prime Ministerial Task Group on Emissions Trading, *Report of the Task Group on Emissions Trading*, Commonwealth of Australia, 2007 ("**Task Group Report**")

<sup>97</sup> For example, "caps and gates" from the NETT Discussion Paper pp 40-43 were similar to the "caps" and "gateways" which appeared in the Task Group Report pp 103-106

<sup>98</sup> For example, possible tests for the quantum of compensation for energy intensive or trade exposed industries, considered in NETT Discussion Paper pp 124-145 and reconsidered with worked simple examples of potential methodologies in Task Group report pp 113-117

In April 2007, before the 24 November 2007 Federal election and before the former Prime Minister's Task Group reported to the Prime Minister, the former Federal Opposition (the Australian Labor Party) commissioned a well-known Australian economist, Professor Ross Garnaut of the Australian National University, to conduct an independent review of the impacts of climate change on the Australian economy. This was expected to be similar to the report that had been prepared by Professor Stern in the United Kingdom. When the Task Group's report exceeded all expectations and the former Australian Opposition was subsequently elected to Government, the Australian Labor Party was still committed to having such a report prepared independently from Government (it had criticised the former Government for not undertaking such a review<sup>99</sup> and had committed to a report that would "embody the independent judgments of its author"<sup>100</sup>). The Garnaut Climate Change Review proceeded even though it was clear that Australia would implement an emissions trading scheme regardless of its outcome.

## The Garnaut Review

Insofar as a scheme design for emissions trading, the *Garnaut Climate Change Review Draft Report*<sup>101</sup> ("**Draft Report**") did not advance the policy context much further than the schemes proposed by the NETT or former Prime Minister's Task Group. By the time it was released on 4 July 2008, political debate over the science of climate change and the need for emissions trading had been silenced by the Task Group and by the polling of climate issues prior to the last election<sup>102</sup>. Much of the Draft Report was dedicated to the science, impacts of climate change on Australia and the potential economic consequences, all of which was eclipsed by political will by the time the Draft Report was issued.

One chapter of the Draft report was reserved for emissions trading. While Professor Garnaut's review adopted a "cap and trade" model and repeated some of the potential design features considered by the NETT and Task Group, some of the approaches advocated differed in a number of key respects that may, ultimately, not advance the policy debate concerning what form an Australian emissions trading scheme should take. For example, the Draft Report proposed a system of "trajectories" under which a series of potential paths for Australia's overall

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<sup>99</sup> Australian Labor Party, *Media release: Garnaut Climate Change Review*, 30 April 2007

<sup>100</sup> Garnaut Climate Change Review, *Terms of Reference*, 30 April 2007 ([http://www.garnautreview.org.au/CA25734E0016A131/WebObj/GarnautClimateChangeReviewTermsOfReference2007/\\$File/Garnaut%20Climate%20Change%20Review%20Terms%20of%20Reference%2007.pdf](http://www.garnautreview.org.au/CA25734E0016A131/WebObj/GarnautClimateChangeReviewTermsOfReference2007/$File/Garnaut%20Climate%20Change%20Review%20Terms%20of%20Reference%2007.pdf))

<sup>101</sup> Garnaut Climate Change Review, *Draft Report*, Commonwealth of Australia, June 2008 ("**Draft Report**")

<sup>102</sup> See, for example, Hon. A Downer MP (Minister for Foreign Affairs), *Media release: Lowy Poll Confirms Confident, Optimistic Australia*, 31 August 2007: "Australians regard climate change as the most important external threat facing Australia"

emissions cap from year to year would be identified at commencement of the scheme<sup>103</sup>.

Australia could switch between these trajectories on five years' notice and the trajectories would in theory give industry some idea of the proposed caps going forward. The previous two scheme designs proposed by the NETT and Task Group had, on the other hand, proposed a system of caps and "gates", under which firm emissions caps would be set for 10 years into the future and that would be followed by two ranges of caps (the "gates" - each of which might be five years, for example), the latter of which would be wider than the first<sup>104</sup>. As each year passes after commencement of the emissions trading scheme, another cap would be set for the 10th year into the future and, after each set of five years, the ranges would also be extended for a further five years each. The consequence was to be, in theory, that industry would have some certainty as to the level of greenhouse gas emissions limitations on the whole of the Australian economy for up to 20 years into the future. Under the Garnaut proposal, by comparison, it would be possible for the Government to significantly change the trajectory of allowable emissions on five years' notice. While this gives the Government more flexibility, it does not give industry the certainty it requires to make investment choices more than 5 years into the future. In this sense, the NETT and Task Group proposals provided a better balance between investment certainty and flexibility.

Although the Draft Report favoured an immediate move to a system where the price of carbon is set by the market, in response to submissions from industry the Draft Report raised the possibility of a transition period from 2010 to 2012 during which time it might be possible to set some controls on the cost of complying with the scheme<sup>105</sup>. Garnaut rejected placing a cap or limit on the cost of compliance of the type that had been proposed by the Task Group, which had proposed a fee for each tonne of carbon by which a liable entity is in shortfall of permits (set effectively low enough to cap the cost of carbon). Instead Garnaut suggested that liable entities might be able to acquit European Union Allowances against their liabilities or (as the less preferred option) that the Government might consider fixing the price of permits to the end of 2012. The former proposal would effectively cap the cost of compliance at the carbon price in the European Union Emissions Trading Scheme anyway and would mean that Australia's emissions would increase above its cap by the number of emissions permits taken out of the European Union system. To be consistent with Australia's obligations under the Kyoto Protocol, there would need to be a concurrent transfer of "Assigned Amount Units" from Europe to Australia in accordance with Kyoto Protocol rules or a cap placed on the number of units that can be transferred, so as to avoid Australia's total emissions exceeding Kyoto Protocol limits. If the latter approach were adopted, and fixed permit pricing imposed, it is unclear how the

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<sup>103</sup> Draft Report pp 365-366

<sup>104</sup> Supra n 97

<sup>105</sup> Draft Report pp 390-392

Government would choose to distribute permits that might otherwise be auctioned if a number of liable entities are prepared to pay the fixed price for the same permits. If the Government held a ballot to distribute fixed price permits, the choice of entities that would be entitled to permits would be made purely on the basis of luck and this would hardly seem to be an appropriate means of allocating a scarce resource in an economy. If discretion were given to a regulator to choose who gets to buy the permits at the fixed price out of a number of willing buyers, the considerations that the regulator might be required to apply would become a political question and open to debate – that is, who is most worthy to be entitled to pollute? Given these difficulties, it is not clear whether any direct form of price control would be effective in a market mechanism and instead, if there is to be a transition period so that companies can adjust, a simpler solution (and one that avoids untested market intervention) would appear to be setting a more modest cap in the first two years.

The Garnaut Review's Draft Report criticised the Clean Development Mechanism ("CDM") to the Kyoto Protocol, under which offsets called Certified Emissions Reductions ("CERs") can be generated from projects in developing countries (as they do not have a binding target for emissions reductions under the Kyoto Protocol) that reduce emissions below a demonstrated business as usual baseline<sup>106</sup>. The Draft Report indicates that the mechanism is "flawed" due to the difficulty in establishing whether a project reduces emissions in addition to the business-as-usual case (known as the test of "additionality"), high transaction costs, the fact that the use of offsets merely allow a concomitant increase in emissions in developed countries and because it provides a financial disincentive for developing countries to take on commitments while ever a revenue stream is received under the CDM<sup>107</sup>. For this reason, the review suggested that the import into Australia's emission trading scheme of CERs from the CDM should be limited as to source and quantity, and should only be possible from relatively lower-income economies without emissions reduction targets<sup>108</sup>. By this Garnaut was suggesting that Australia should not import offsets under the CDM from economies like India and China. The current political reality, however, is that – in the absence of support for binding targets from wealthier developing countries – establishing clean development projects in India and China may well be better than not at all. While it is true that the CDM is not free of difficulties and the emissions reductions achieved under the CDM might be negligible compared with the rate at which emissions are growing in increasingly wealthy developing economies like India and China, the CDM has been successful in promoting technology transfer (a benefit that Garnaut has acknowledged) and spreading awareness of climate change in developing countries. Likewise, even the commentators on which Garnaut relies to support the difficulty of proving

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<sup>106</sup> *Kyoto Protocol to the United Nations Framework Convention on Climate Change ("Kyoto Protocol")*, Article 12

<sup>107</sup> Draft Report p 279

<sup>108</sup> Id p 378

"additionality" under the CDM do not condemn the mechanism altogether and although they advocate a more limited role for it suggest that "[t]he [CDM] system can work better, if not perfectly, provided it pursues substantial reforms"<sup>109</sup>.

In effect the Garnaut review was a useful review and summary of some of the science and potential design proposals for an Australian emissions trading scheme, but given the substantial policy history that had gone before the Garnaut review it has not changed the course of the policy debate concerning the shape that emissions trading should take in Australia. Indeed, its release was overshadowed by the release of the Government's Green Paper on 16 July 2008, which for the first time set out in detail the new Australian Government's thoughts on emissions trading.

### **The Australian Green Paper**

The new Government confirmed its proposal to implement a "cap and trade" emissions trading scheme in its Green Paper, to be known as the *Carbon Pollution Reductions Scheme* ("**CPRS**"). The cap and trade model advocated in the Green Paper is similar to the type that is already well-known internationally and outlined above<sup>110</sup>. The Kyoto Protocol itself is a type of cap and trade emissions trading scheme under which countries are the liable entities, by contrast with the domestic emitters that might be liable under a domestic scheme. The Government confirmed that its CPRS will set a series of limits on the total tonnes of carbon dioxide equivalent emissions that entities covered by the scheme are entitled to emit, each such limit being applied over a 12 month period<sup>111</sup>. Entities covered by the scheme will be required to obtain and annually surrender "carbon pollution permits" (an allowance or permit by any other name) for every tonne of carbon dioxide equivalent greenhouse gas emissions for which they are responsible or deemed to be responsible. The Government will issue a number of permits corresponding to the total "cap" that it wishes to achieve, each of which is tradeable. In this sense, the price of carbon (in the absence of fixed-price permits proposed by Professor Garnaut<sup>112</sup>) is established by the worth that liable entities place on each permit, given the finite supply of permits and the total demand for them across all entities covered by the CPRS.

This can be contrasted with a carbon tax, where the price of each tonne of carbon is set by the Government. In theory, under a cap and trade model, the price of carbon will closely reflect the

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<sup>109</sup> M. Wara and D. Victor, *A Realistic Policy on International Carbon Offsets*, PESD Working Paper #74, April 2008 p 19

<sup>110</sup> See pp 2 and 3 above

<sup>111</sup> Green Paper p 74

<sup>112</sup> *Supra* n 26

minimum cost that is necessary to achieve the cap, whereas a tax set by the Government could be higher (or, if set too generously, lower) than what is necessary to achieve a greenhouse gas emissions reduction target. If a tax is set too high, entities covered by the scheme pay too much to achieve its environmental objectives, which costs are passed onto the broader economy. If the tax is set too low the tax will be insufficient to achieve the environmental objectives of the scheme. On the other hand, if the CPRS rules are complex when they are released (leading to higher transaction costs), if the market established is not sufficiently liquid or if there are barriers to exchange of pricing information, the price of carbon under emissions trading could be higher than it needs to be and efficiency gains from having the market set the price could be lost.

### **- "Cap" trajectories**

The Green Paper does not express a view on the likely trajectory of caps on greenhouse gas emissions that will be set by the Government, referring only to the Government's previously stated commitment to reduce Australia's greenhouse gas emissions by 60% below 2000 levels by 2050<sup>113</sup>. At this stage, the Government proposes to publish a decision on the caps in its White Paper, that is to be released in December 2008 with draft legislation on the CPRS. While the Green Paper adopts the language of "trajectories" used by Professor Garnaut, the paper effectively adopts the system of "caps and gates" proposed by the NETT and the Task Group but with a shorter horizon of firm caps. It is proposed that caps will be set for 5 years into the future<sup>114</sup> and a medium-term range (or "gateway") would be established (possibly until 2020) with upper and lower bounds<sup>115</sup>. Each year the caps would be extended by another year so that firm caps are always known for the next 5 years at any point in time and every 5 years the gateways would similarly be extended for a further 5 years. While this approach provides some investment certainty, it is in effect similar to setting a longer trajectory and allowing changes between trajectories on 5 years notice. Any investment decisions cannot be made with any certainty that carbon constraints beyond 5 years into the future will be tighter or weaker than the present path of the caps, only that the cap will lie between the established medium-term range.

### **- Coverage and commencement**

While the Government estimates there will be approximately 1000 liable entities and that more than 99% of all "firms" in Australia will not need to be directly involved in the regulation of emissions or the obligation to acquire permits<sup>116</sup>, the reality of the CPRS is that these key liable entities are employers and buyers or sellers of goods or services so that the costs of complying with the scheme will be passed up or down the supply chain, onto the broader economy and, ultimately, to consumers. The emissions trading scheme will change the way that the economy

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<sup>113</sup> Green Paper p 65

<sup>114</sup> Id pp 173-174

<sup>115</sup> Id pp 180-185

<sup>116</sup> Id p 13

operates and create a price signal throughout the economy in connection with the cost of carbon – even where greenhouse gas emissions underlie goods or services that do not obviously or directly cause emissions. Liable entities that are able to either adapt to the cost of carbon, or can produce sufficient revenue from each tonne of carbon so that they can meet the additional cost of the CPRS, will survive. Activities undertaken by other liable entities may no longer be viable and those liable entities will be forced to change or will face becoming unviable themselves.

The Australian Government proposes to implement a scheme with broad coverage from its likely commencement in 2010<sup>117</sup> - no narrower in scope than the proposal of the former Government - which would include direct emissions from facilities emitting over 25 ktCO<sub>2</sub>-e per annum<sup>118</sup> from (broadly) stationary energy, transport, fugitive emissions, industrial processes and waste sectors<sup>119</sup>. CPRS will encompass all of the greenhouse gases covered by the Kyoto Protocol<sup>120</sup>. This is an early start given that the greenhouse gas emissions and energy reporting regime which will underpin CPRS, the *National Greenhouse and Energy Reporting Act 2007* (Cth) ("**NGER Act**"), only commenced on 1 July 2008 and industry is still grappling with how it will implement this new legislation. CPRS will, if the Government meets its proposed timetable, commence less than 12 months after the first set of data is obtained under the NGER Act. Like the former Prime Minister's Task Group, the Green Paper proposes to place an obligation to surrender permits on upstream fuel suppliers for greenhouse gas emissions that are to be caused by the combustion of fuels that they supply<sup>121</sup>. In addition, bulk importers of synthetic greenhouse gases and large importers of equipment containing synthetic gases would be responsible for surrendering permits corresponding to those imports<sup>122</sup>. Agriculture would not be included in the scheme initially (before at least 2015) until a practical means of estimating and reporting emissions can be developed with the industry<sup>123</sup>. Owners of forests can elect whether or not to participate<sup>124</sup> - a decision that will likely be made based on whether the forest can be recognised as a net carbon sink (see "Offsets and sinks" below).

To ease the political blow of including petrol in the scheme from its commencement, given the inevitable price increases when the cost of carbon is no longer an externality, the Government is proposing to offset the increased cost of fuel as a result implementing the CPRS with a cut to fuel taxes on a "cent for cent basis"<sup>125</sup>. The Government proposes to reassess the offset every three years and sends a strong signal in the Green Paper that the measure is only transitional

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<sup>117</sup> Id p 88

<sup>118</sup> Id p 98

<sup>119</sup> Id pp 99-138

<sup>120</sup> Id p 96

<sup>121</sup> Id pp 99-102

<sup>122</sup> Id pp 104-105

<sup>123</sup> Id pp 123-126

<sup>124</sup> Id pp 127-134

<sup>125</sup> Id p 278

while businesses and consumers have an opportunity to make decisions informed by the long-term intention of the scheme<sup>126</sup>. This measure will of course initially be inefficient given the cost of administering the fuel tax cuts and the fact that, if the CPRS and tax measures operate as intended, there will be no net carbon price signal applied to petrol. That is, applying the CPRS to transport will present a net cost to Government with no net environmental benefit in the first three years. However, politically this may have been the only way to apply the mechanics of the scheme to fuel consumption, so as to prepare fuel consumers and the transport industry for the processes that must be followed in a carbon constrained future. Where industries would not benefit from a cut to fuel excise (for example, in the agricultural and fishing industries) the Government proposes to provide a rebate equivalent to the excise cuts<sup>127</sup>.

#### **- Offsets and sinks**

Given the broad coverage of the scheme proposed, the Government has left few opportunities for carbon offsets to play a role in the CPRS. "Carbon offsets" most often represent a tradable credit awarded where greenhouse gas emissions can be reduced below a business-as-usual level of emissions. In some other emissions trading schemes around the world, offsets can be used like permits to enable a liable entity to emit an additional 1 tCO<sub>2</sub>-e of greenhouse gas emissions for each offset that is surrendered to the regulator. Offsets, however, are only possible if the activity that reduces greenhouse gas emissions is carried out in a sector that is not otherwise covered by the obligation to surrender permits under the emissions trading scheme. If greenhouse gas emissions are reduced by 1 tCO<sub>2</sub>-e in a sector that is covered by an emissions trading scheme the entity that would have otherwise been liable to surrender a permit for that emission avoids the need to do so. This frees up the permit for use by that person (or another entity) and so, if the reduction in emissions were also to generate an offset, the spare permit and new offset can be used to effectively allow 2 tCO<sub>2</sub>-e to be emitted where only 1 tCO<sub>2</sub>-e has been reduced: a net increase in emissions of 1 tCO<sub>2</sub>-e.

For this reason, only activities that are not covered by the CPRS, effectively agriculture, would be entitled to generate offsets until those activities are included in the scheme. As the Government takes the view that "*[o]ffset schemes are administratively complex and require considerable judgement to determine [business as usual] baselines*" and because effectively only agriculture would be eligible to create offsets (which could be included in the scheme as soon as 2015 anyway) the Government is not proposing in the Green Paper to establish any offset system for the CPRS at all<sup>128</sup>. The Government will review this for any emissions sources that cannot be included in the scheme post-Kyoto Protocol. This will mean Australia will forgo

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<sup>126</sup> Id p 17

<sup>127</sup> Id p 101

<sup>128</sup> Id pp 137-138

opportunities up to 2015 for farm businesses to create offsets under the CPRS and so generate a revenue stream from reduced emissions in animal management practices and the like.

Agricultural projects have been a popular source of emissions reductions in Mexico and South America under the CDM (albeit that Australia, as an Annex B country, is not eligible to participate in that mechanism).

Offsets are not, however, the only way that liable entities can legitimately generate additional tonnes of emissions over and above the permits originally issued under the scheme cap. Growing forests capture carbon from the atmosphere and, unlike offset projects, they do so without being the source of the emissions that are sought to be reduced. In this sense, forests are "sinks" that can capture additional carbon but that do not free up a permit for each tonne of carbon that is captured. For this reason, even if forestry and agriculture are ultimately all covered by the scheme, there is no increase in emissions (unlike offset projects) if the carbon captured in forestry projects is recognised with credits that can be used to offset other emissions covered by the CPRS. Consequently, the Government is proposing to enable owners of the rights to carbon captured in forests ("**Forest Landowners**") to elect to have their forest participate in the scheme<sup>129</sup>. Although detailed design is to be determined, it is expected that for each net tonne of carbon dioxide equivalent emissions captured in eligible forests, Forest Landowners that opt-in would be issued with a permit by the Government that could be traded in the CPRS<sup>130</sup>. Likewise, for each net tonne of carbon dioxide equivalent emissions in those forests that is lost, the Forest Landowner would be required to surrender a permit.

If forest plantations can be established at a lower cost than permits can be purchased at auction or from third parties, this will contribute to reducing the overall cost of complying with the CPRS across the economy and for those entities that choose to obtain permits from plantations. Entities that are liable to participate in the scheme can establish forestry plantations to obtain further permits, or can buy permits from others that have established forestry plantations either directly or from the secondary market. These permits would effectively enable them to emit more greenhouse gases than would have been possible with the permits that the Government issues (by auction or otherwise) under the scheme cap alone.

It is proposed that the rules for this part of the scheme would operate in parallel (and so be no less onerous than) Australia's obligations under the Kyoto Protocol to account for forestry activities<sup>131</sup>. For this reason, forestry activities that reforest land which had been deforested by 31 December 1989 will be eligible to generate permits<sup>132</sup>. Projects that merely avoid

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<sup>129</sup> Id pp 129-132

<sup>130</sup> Id p 127

<sup>131</sup> Id pp 17, 133 and 461

<sup>132</sup> In accordance with the definitions of *afforestation* and *reforestation* under the Kyoto Protocol

deforestation<sup>133</sup> or that reforest land that was cleared after that date will not be eligible. There are other land-use changes for which Australia could elect to account under Article 3.4 to the Kyoto Protocol, including certain forest, grazing or cropland management activities and revegetation (not meeting the afforestation or reforestation definitions), but Australia has elected not to do so for the first commitment period of the Kyoto Protocol (2008-2012)<sup>134</sup>. As Australia has not elected to account for other land use changes it is likely it will not be possible to generate permits from stored or avoided emissions as a result of these activities, as this would add permits into the CPRS market that would not coincide with emissions reductions for which Australia could be recognised under its international obligations.

**- The nature of permits and how they will be distributed**

The Government proposes to distribute the majority of permits by way of auction, but to move to 100% auctioning over time<sup>135</sup>. Up to 30% of permits are to be allocated for distribution free of charge at the commencement of each compliance year to trade exposed, energy intensive industries, to provide transitional support to avoid the risk of those entities moving processes offshore and so merely shifting emissions (and investment) elsewhere<sup>136</sup>. The permits are proposed to be tradable personal property which could only be extinguished with compensation<sup>137</sup>. This would appear to rely not only on any legislation that might be introduced for the CPRS but also on Australia's Constitutional protections for acquisition of "property" on just terms<sup>138</sup> and the array of rights that have been recognised to be "property" within the meaning of those provisions<sup>139</sup>. However, this might be no real impediment to the Federal Government choosing to repeal any compensation legislation and extinguish permits if it were determined to do so, given that there is no Constitutional protection in Australia for property that is merely extinguished in the course of a Government performing regulatory functions and not actually "acquired":

*The statutory modification or extinguishment of a permit or an interest in a permit is not an acquisition of property by the Commonwealth, for the Commonwealth was under no liability reciprocal to the permit or interest and acquires no benefit by the modification or extinguishment.*<sup>140</sup>

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<sup>133</sup> Green Paper pp 134-135

<sup>134</sup> Department of Climate Change, *The Australian Government's Initial Report under the Kyoto Protocol*, Australian Government, 2008 p 4

<sup>135</sup> Green Paper p 256

<sup>136</sup> Id pp 292-297

<sup>137</sup> Id p 150

<sup>138</sup> *Australian Constitution Act 1901* s 51(xxxi)

<sup>139</sup> *Telstra Corporation Ltd v Commonwealth* (2008) 243 ALR 1 at 13-16

<sup>140</sup> *Commonwealth of Australia v WMC Resources Ltd* (1998) 152 ALR 1 at 12

While it is conceivable that the Commonwealth might be obtaining a material benefit by extinguishing CPRS permits if in so doing it afforded the Commonwealth more Assigned Amount Units ("AAUs" - effectively permits under the Kyoto Protocol) than it would have had if the CPRS permits were used by its owner to generate more emissions, it is questionable whether this would be a relevant acquisition requiring compensation on just terms. When a right to mine on Commonwealth land was sterilised by the Commonwealth it was held to be a compensable acquisition of property because the miner lost the right to mine and the Commonwealth lost a reciprocal liability to have its minerals removed<sup>141</sup>. However, if the Commonwealth were to extinguish a CPRS permit to emit, avoiding the need for (or freeing up) another permit to emit (AAU) under its Kyoto Protocol obligations, it is questionable whether the right extinguished and the benefit acquired (or liability avoided) are sufficiently reciprocal – even though the right extinguished need not be the same as the right gained or liability avoided by the Commonwealth<sup>142</sup> – given that the CPRS permit is itself an instrument implemented by the Commonwealth for purposes that include meeting Australia's international law obligations under the Kyoto Protocol.

The Green Paper also proposes that permits under the CPRS would be a "financial product"<sup>143</sup>. This is in some ways akin to making wheat or gold a "financial product" in the sense that permits under the CPRS represent the underlying tradable commodity. If permits (as distinct from other products that are generated from them) were literally added to section 764A of the *Corporations Act 2001* as a financial product alongside derivatives and securities, services provided in connection with carbon trading could (without further amendment to the law) be regulated in a way that could reduce the liquidity of what should effectively be a simple commodities market in which liable entities can freely participate without high transaction costs. It will remain to be seen what approach the Government takes and the consequences this has for licensing and financial services regulation in the context of carbon trading in Australia.

Under the Government's preferred position, CPRS permits could be unlimitedly banked<sup>144</sup>, meaning they may be surrendered by liable entities in any year after they are issued and would not expire. The Government is proposing a limited borrowing scheme that would allow liable entities to "borrow" a certain percentage of permits from the following year to meet liabilities in the current year<sup>145</sup>. Although this affords more flexibility to comply with present year obligations, the scheme cap will effectively be tighter (and the carbon price potentially higher)

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<sup>141</sup> *Newcrest Mining (WA) Ltd v Commonwealth* (1997) 147 ALR 42 at 48 (per Brennan J, albeit dissenting on other grounds) and 129 (per Gummow J)

<sup>142</sup> *Georgiadis v Australian And Overseas Telecommunications Corporation* (1994) 119 ALR 629 at 633

<sup>143</sup> Green Paper p 151

<sup>144</sup> Id p 153-155

<sup>145</sup> Id p 157-158

in the following year. This is similar to the mechanism already in operation under GGAS to carry a certain percentage of any shortfall in offsets over to the following year<sup>146</sup>.

For trade exposed, energy intensive industries, the assessment of eligibility to receive free permits is proposed to be made on the basis of "activities" and not on a whole-of-firm or industry level, so that activities with an emissions intensity over 2,000 tCO<sub>2</sub>-e/ \$ million revenue would receive permits corresponding to around 90 percent of industry average emissions per unit of output, while activities with emissions intensities between around 1,500 and 2,000 tCO<sub>2</sub>-e/ \$ million would initially receive permits corresponding to around 60 percent of industry average emissions per unit of output<sup>147</sup>. While taking industry average emissions will mean that firms will not be rewarded with free permits for emissions that are in excess of industry average, by restricting the eligibility assessment to firms that exceed a certain emissions intensity per unit of revenue the Government will take no account of firms that could be highly trade exposed and work to small margins. For some such firms, a small increase in their costs per unit of revenue could make the return insufficient for some processes to be undertaken in Australia. The intensity threshold appears aimed at limiting the number of trade exposed industries that receive free permits based on an assumption that if the increase in cost is low per unit of revenue then most such trade exposed industries will not be seriously affected. It remains to be seen whether this is the case for low margin firms.

The Government will separately establish the Electricity Sector Adjustment Scheme ("ESAS") to provide limited direct assistance to existing coal-fired electricity generators<sup>148</sup>, which could include free permits<sup>149</sup>. Assistance to adjust to the scheme will also be provided to households, predominantly through increases to Commonwealth benefits and allowances, and through the tax system<sup>150</sup>. The detail of these measures is to be the subject of consultation.

#### **- Penalties, price controls and international linkages**

The Government does not propose a definitive penalty for non-compliance, rather "flexible measures" are advocated to seek to achieve compliance voluntarily<sup>151</sup>. The Green Paper indicates that a penalty could be imposed for surrendering fewer permits than required<sup>152</sup>, but no potential measure of the penalty is suggested.

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<sup>146</sup> ES Act s 97BE

<sup>147</sup> Green Paper pp 320-321 and 330

<sup>148</sup> Id pp 371-391

<sup>149</sup> Id pp 385-386

<sup>150</sup> Id p 278

<sup>151</sup> Id p 215

<sup>152</sup> Id p 216

At this stage the Green Paper is proposing to place a cap on the price that businesses would be required to pay for permits (sufficiently high that it would unlikely be used) between compliance years 2010/2011 to 2014/2015<sup>153</sup>. The Government suggests this could be achieved through an administrative penalty or by providing an unlimited further supply of permits at a fixed price (in addition to permits issued in accordance with the cap). If the price cap is not high enough to make its use prohibitively expensive and is established to allow businesses to "buy out" the obligation to surrender permits by paying the capped price, the environmental integrity of the scheme will be compromised because total emissions allowable across all covered sectors would be greater than the cap set under the scheme. If the emissions caps are ultimately set at such a point so that there is, at least in the transitional period, only a limited difference between actual and targeted emissions and if a proportion of entities were to choose an administrative buy-out while others hoard permits, the price of permits may crash when those banked permits (effectively in excess of the intended cap) are later brought to the market. Either scenario can be avoided with a sufficiently high administrative penalty or a requirement to make good any permits in shortfall in the following year.

Gone from the Green Paper is the suggestion in Garnaut's Draft Report to issue all permits at a capped price or to allow European Union Allowances to be acquitted as a form of price cap<sup>154</sup> – even from the summary of the Draft Report in the Green Paper<sup>155</sup>. The Government does, however, propose to establish some links between the CPRS and global emissions trading. In particular, the Green Paper proposes that:

- liable entities would be able to use some Kyoto Protocol units for compliance with the CPRS (subject to possible limits or restrictions which have yet to be proposed), being Emission Reduction Units created under the Joint Implementation Mechanism, Removal Units, and CERs created under the CDM (with the exception of CDM forestry offsets)<sup>156</sup>;
- liable entities could not use Assigned Amount Units under the Kyoto Protocol<sup>157</sup> or any international non-Kyoto units to comply with the CPRS<sup>158</sup>. This will include European Union Allowances and New Zealand Units;
- a permit under the CPRS would not be attached to one of Australia's Assigned Amount Units under the Kyoto Protocol – these units would be registered separately, and traded separately, from Kyoto Protocol units<sup>159</sup>. This is not the approach the European Union has implemented;

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<sup>153</sup> Id p 165

<sup>154</sup> Supra n 26

<sup>155</sup> Id p 465

<sup>156</sup> Id pp 236-238

<sup>157</sup> Id pp 234-236

<sup>158</sup> Id pp 242-243

<sup>159</sup> Id p 229

- CPRS permits could not be converted to Kyoto Protocol units for trade internationally<sup>160</sup>; and
- projects under the Joint Implementation Mechanism to the Kyoto Protocol cannot at this stage be undertaken in Australia: not in covered sectors (even in the case of forestry sinks where the additional permits generated might be exported under the Kyoto Protocol as Emission Reduction Units) and not in uncovered sectors unless offsets can be generated (which they cannot at this stage)<sup>161</sup>.

In effect, the global linking proposed at this stage is unilateral and conservative. A measured approach to progressively linking the CPRS to the global carbon market may well prove to be sensible. However, the benefits that come from a larger and more liquid linked market – and a commodity that the banking and financial services industry will doubtless wish to see become easily tradable across jurisdictional borders – mean that more global linking and convergence between the carbon that is traded in different markets, in one form or another, is inevitable.

### **The road to the White Paper**

As for any other markets involving the sale and purchase of essential commodities for businesses, the banking and financial services sector will play a central role in the carbon market including by backing acquisitions of permits, financing emissions reduction projects and developing funds or products that raise capital, offer exposure to carbon trading or manage risks. Many Australian companies in this sector have already gained experience in international carbon trading or in financing projects under the domestic precursors to the CPRS.

Of the 1000 or so Australian businesses operating in the broader economy that are expected to have direct liabilities under the CPRS, the leaders will come to grips with what Australia's proposed emissions trading scheme could mean for them by the time submissions on the Green Paper close on 10 September 2008. Many other companies that are not directly liable under the scheme may nonetheless have considerable real liabilities as a consequence of carbon costs being passed to them through their supply chains or even upwards from their customers. Even some entities within groups in the banking and financial services sector will be subject to a direct liability under the scheme.

The final detail of the scheme will not be known until the proposed White Paper is released in December. However, the long experience of carbon policy development in Australia and the

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<sup>160</sup> Id pp 244-246

<sup>161</sup> Id pp 246-247

proposed mid-2010 start for CPRS means the demand for carbon financial services and products in Australia started long ago.