

# Understanding the Carbon Price Mechanism

2012 marks the commencement of the Carbon Price Mechanism (CPM). From 1 July 2012, large emitters will be subject to a carbon pricing scheme, which will function first as a fixed price scheme for the initial three years, before transitioning to a floating price "cap and trade" scheme from year four onwards.

The Climate Change debate, with its associated terminology and acronyms, has featured prominently in Australian politics for the last few years. But what is this looming "carbon price" and what does it mean for businesses and individuals?

This paper answers questions about the CPM, placing it in context and explaining its structure and operation, to assist you in understanding its implications for your business.

## What is the history of the CPM?

The carbon price issue has featured on the Australian political agenda for decades. Both the Keating and Howard Governments developed climate change policies. Following the Rudd Government's failed attempt to pass the Carbon Pollution Reduction Scheme legislation through Parliament in 2009, its implementation was delayed until the end of the first commitment period of the Kyoto Protocol in 2012.

After the August 2010 election, the Labor minority Government established the Multi-Party Climate Change Committee, comprised of representatives of Labor, the Greens and two independents, to again discuss the possibility of implementing a carbon price. The result is the Clean Energy Future package released in July 2011.

## What is the CPM?

The CPM is one element of the Australian Government's plan for a Clean Energy Future package. The CPM is a two-stage approach to pricing carbon. From 1 July 2012 liable businesses will be required to pay a fixed price per tonne of covered greenhouse gas (GHG) they emit into the atmosphere each year.

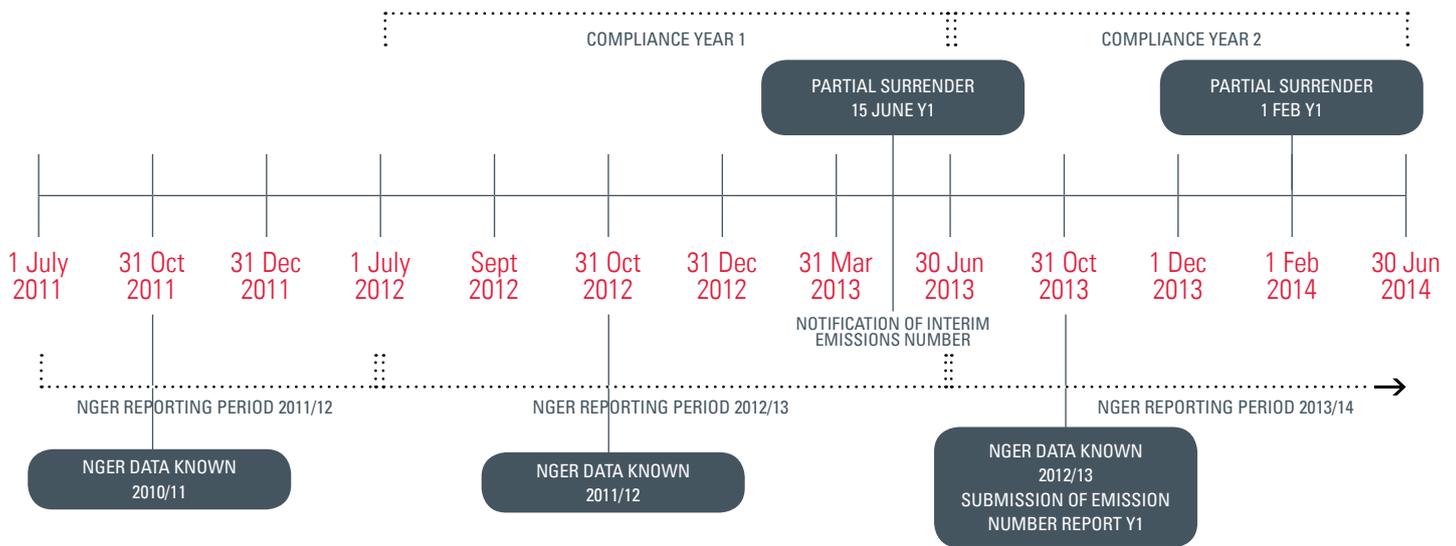
The CPM will then move to a "cap and trade" emissions trading scheme from 1 July 2015. In this second phase, the Government will issue a fixed number of carbon units, capping emissions and allowing the market to set the price. If liable businesses do not surrender one carbon unit, for every tonne of GHG which is either a "covered emission" or embodied in natural gas supplied to a small user of gas, then the liable business must pay a shortfall charge.

## Why is the CPM important?

Under the 2010 Cancun Agreements made under the United Nations Framework Convention for Climate Change, Australia is to reduce its total GHG emissions by 5% by 2020, and by 80% by 2050 (compared with 2000 levels). Australia also has international commitments under the Kyoto Protocol which may be extended under the Durban Platform, if those negotiations are concluded.

The CPM is part of the Australian Government's strategy to reduce GHG emissions to meet its international commitments and to promote the development of clean energy innovation and solutions within Australian industry. By introducing a carbon price into the Australian economy the CPM creates a market mechanism to provide an economic incentive to reduce the emissions of GHG. Further, the cost imposed on emitters will notionally pass through the supply chain, resulting in increased costs for goods and services depending on the emissions intensity of the production processes. For emitters, the incentive is to minimise direct liability to acquire carbon units and remain competitive by cost-effectively reducing emissions.

## CPM – Reporting



### Clean Energy Future package: Where does the CPM fit?

The CPM is created under the Clean Energy Act 2011 (Cth), one of 19 Acts that collectively comprise the Clean Energy Future package. The CPM is one of four components of the Clean Energy Future package, the other three being the Carbon Farming Initiative, improving energy efficiency and investing in renewable energy.

#### Carbon Farming Initiative

The Carbon Farming Initiative establishes an offset scheme for the land sector, whereby landholders can earn and sell carbon credits for sustainable, emission reduction activities. Certain offset credits generated under the Carbon Farming Initiative can be used to meet CPM obligations.

#### Investing in renewable energy

The Government will establish a **Clean Energy Finance Corporation** to invest \$10 billion of new funds into the commercialisation of renewable energy and energy efficiency technologies, along with other programs to encourage business and community investment in renewable energy, energy efficiency and land sector abatement.

### Who is liable under the CPM?

The Government estimates that approximately 500 of the nation's largest GHG emitters will be directly liable under the CPM.

#### Liable entities include:

- the person who has operational control of a **facility** which emits 25,000 tonnes of covered emissions annually (scope 1 emitters);
- the person who has operational control of a **landfill facility** which emits 25,000 tonnes of covered emissions annually (excluding legacy emissions); and
- **natural gas suppliers** who supply natural gas to a person without an "obligation transfer number" where the gas is partly or wholly used by or on behalf of the recipient, and the gas is withdrawn from a natural gas supply pipeline for that purpose.

"Covered emissions" include greenhouse gas emissions from:

- the combustion of energy sources;
- fugitive emissions (such as from coal mines or natural gas extraction);
- industrial process emissions; and
- waste emissions

but do not include emissions from the combustion of liquid petroleum fuel (petrol, diesel or avgas), LPG, LNG or CNG, where that fuel has been subject to Australian customs tariffs or excise tariffs (because the tariff regime has its own carbon price mechanism). Emissions from the combustion of biomass, biofuel or biogas are also excluded, because they are regarded as environmentally neutral.

As liability is facility-based, parent companies are not liable; rather the person who has operational control of a facility is liable. Note that a "facility" is defined to be an activity, rather than a place or thing. Different persons can have "operational control" of different activities at the one location. The legislation contains various tests to determine which person has "operational control" of an activity.

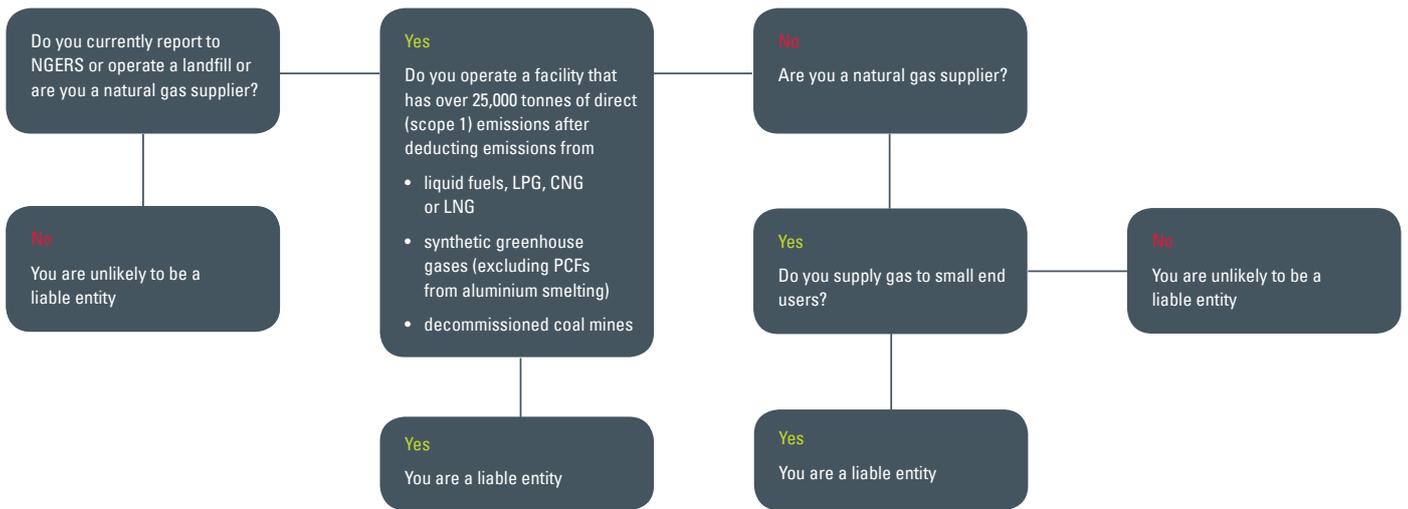
#### Third party operators

In most circumstances the owner of a plant will have operational control of the activities at the plant and is therefore liable. However, the owner may contract out certain operational activities to third parties, who will then need to comply with the reporting obligations under the **National Greenhouse and Energy Reporting System (NGERS)** and meet the facility's liability under the CPM unless it enters into a liability transfer arrangement, by obtaining a Liability Transfer Certificate and Reporting Transfer Certificate.

## Liability transfer

Liability may be transferred from an entity with operational control to a company within that company’s corporate group, or to an entity with “financial control” of the facility. This provides greater flexibility for businesses. A Liability Transfer Certificate will only be issued to an applicant that has, and is likely to continue to have the capacity, access to information and financial resources necessary for it to comply with the obligations under the CPM.

### Am I liable?



## Joint ventures

For unincorporated joint ventures where no one person has operational control of a facility, the liability for emissions is usually spread between the joint venture participants in proportion to their interest in the facility. In certain circumstances, unincorporated joint ventures may need to apply to the Clean Energy Regulator for determinations as to who has operational control, after which the regulator will make a declaration of the share of liability.

### What emissions are excluded from the CPM?

The following emissions will be excluded from the CPM:

- emissions from the agricultural and land sector including forestry and fisheries;
- emissions from the combustion of biofuels and biomass; and
- emissions from legacy landfill waste and decommissioned coal mines.

### Effective liability for emissions of synthetic gases and the transport sector

While there will be no liability under the CPM for emissions of synthetic gases, an effective carbon price will be applied to certain synthetic greenhouse gases that are excluded from the CPM through changes to import and manufacturing levies applicable to those gases.

Similarly, while emissions from the transport sector will not attract liability under the CPM, an effective carbon price will be applied by changes to existing fuel excise and fuel tax credit schemes which will apply to:

- domestic aviation;
- domestic shipping;
- rail transport; and
- off-road transport use of liquid and gaseous fuels.

Those fuel users may be able to opt in to the CPM from 1 July 2013, and surrender carbon units rather than have their fuel excise credits reduced by the carbon price, by applying to the Clean Energy Regulator.

### What is the cap on emissions?

#### No cap on emissions during fixed price period

As liable entities must pay a shortfall charge unless they obtain and surrender a

carbon unit for every tonne of GHG emitted, a “cap on emissions” effectively equates to a cap on the number of tradable carbon units. During the initial three-year fixed price period, from 1 July 2012 until 1 July 2015, there will be no limit on the number of carbon units issued and therefore there will effectively be no cap on emissions.

#### Emissions capped during flexible price period

From 1 July 2015, the number of carbon units available will be limited and the finite supply will influence their price.

The extent of the cap will be based on the recommendations of the new Climate Change Authority (CCA). It is expected that the annual cap will be set consistently with Australia’s emission reduction targets.

The first five years worth of caps will be announced in 2014. Each year thereafter, the cap for the fifth year will

be announced to maintain five years of known caps at any given time. If there are no regulations in effect which declare the emissions cap in the year from 1 July 2015 to 1 July 2016 and after, a default cap will apply, which will be determined using prescribed formulae but is intended to ensure that Australia achieves its unconditional commitment to reduce emissions by 5% by 2020 (based on 2000 levels).

### How much will a carbon unit cost?

#### Fixed price period

In the first three years of the CPM, from 1 July 2012 until 1 July 2015, carbon units will be issued at a fixed price:

- \$23/ tonne in 2012-2013
- \$24.15/ tonne in 2013-2014
- \$25.40/ tonne in 2014-2015

#### Flexible price period

From 1 July 2015, the CPM will enter an emissions trading phase where a flexible carbon unit price will commence. The price will be determined by the market at auction and the caps on the number of carbon units sold will determine the carbon price.

Modelling by Treasury suggests that the price of a carbon unit in 2015 is likely to be approximately \$29.

For the first three years of the flexible price period, a transitional carbon price ceiling and floor will be implemented to manage price volatility and increase stability and certainty.

**The price floor = \$15 + 4% pa in real terms.**

**The price ceiling = \$20 above the expected international carbon unit price + 5% pa in real terms.**

The price floors and ceilings will be reviewed by the CCA, who will advise the Government on whether price controls at these settings should continue.

### Which credits are eligible for surrender?

#### Fixed price period

The Clean Energy Regulator will sell, and in some cases issue for free, carbon units, which will be surrendered automatically on purchase. Carbon units allocated under a compensation arrangement will be automatically surrendered in February following the compliance year.

Liable entities must surrender their units so as to avoid an emissions liability shortfall charge in two stages:

- an interim surrender obligation of 75% of their emissions obligation by 15 June of the relevant compliance year for emitters exceeding 35,000 tonnes CO<sub>2</sub>-e per annum, and
- a "true up" for the remainder of the obligation by 1 February following the relevant compliance year

While it is prohibited to use international units during this period, liable entities may meet 5% of their obligation by using (Kyoto-compliant) Australian Carbon Credits Units (ACCUs) issued under the Carbon Farming Initiative. It is also prohibited to bank, borrow or export fixed price carbon units (there is an exception for ACCUs). Fixed price carbon units allocated under a compensation arrangement can be transferred amongst entities within their vintage year.

#### Flexible price period

Once the "cap and trade" scheme is under operation, the CPM allows for unlimited banking and limited borrowing of carbon units, including carbon units issued with a vintage during the flexible price phase.

Liable entities can meet CPM obligations if, before 1 February following the compliance year and by electronic transfer to the Clean Energy Regulator, they surrender:

- carbon units purchased at auctions conducted by the Government or on the secondary market;

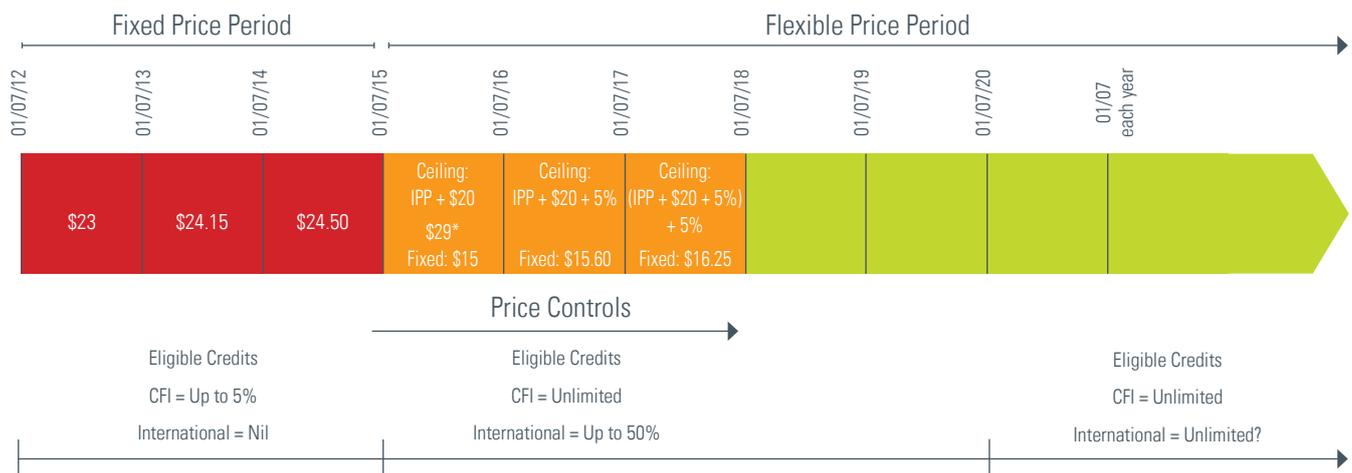
- carbon units allocated for free as part of the industry assistance or as compensation to industries which undertake emissions intensive trade exposed activities;
- eligible ACCUs generated under the Carbon Farming Initiative or purchased on the secondary market including some non-Kyoto ACCUs that satisfy criteria to be set out in regulations;
- banked carbon units from the following vintage year to discharge up to 5% of liability; and
- eligible international emissions units equivalent to 50% of the liability up to 2020. The CCA will review in 2017 whether this limit should be extended beyond 2020.

Eligible international emission units are those recognised by the Government and will be specified in the regulations. They will include Kyoto Emission Reduction Units (ERUs) and some types of Certified Emission Reduction (CERs) credits. The Government is also considering allowing New Zealand Units (NZU) and European Union trading scheme units. Using eligible international emissions units may attract an additional charge under the Clean Energy (International Unit Surrender Charge) Act 2011 in the first three years of the flexible price period to maintain the floor price current at that time.

The export of carbon units (except Kyoto-compliant ACCUs) will be prohibited while domestic price controls are in place (ie. price floor and ceilings) except as part of a bilateral arrangement. Unrestricted export of carbon units will be permitted only when there is no longer a price ceiling and floor in place.

### What charges apply?

Technically, the surrender of a carbon unit is not compulsory. However, during the fixed price period if a liable entity does not surrender sufficient carbon units under the CPM, it will be liable to pay a carbon tax of 1.3 times the fixed price of a carbon unit which is applicable at the relevant time.



\*Treasury Modelling Estimate on Core Policy Scenario

This carbon tax will increase during the flexible price period to twice the average market price of carbon units.

### Which entities may be entitled to compensation?

Business and individuals which are strongly impacted by the flow-on effects of increased input costs may be compensated by the Government through its various assistance packages:

- **Households:** \$14.9 billion will be provided to households to offset the price rises likely to be passed from liable entities to consumers. These measures will be implemented through changes to tax and benefits schemes with emphasis on low- to middle-income households.
- **Jobs and Competitiveness Program:** \$9.2 billion worth of carbon units will be issued free of charge to emissions-intensive trade exposed industries. This will apply to specific industries which export products and must compete with products where domestic carbon prices are not in place. The liable entities for highly emissions-intensive trade-exposed activities will receive 94.5% of their activity's benchmark emissions intensity as free carbon units. Liable entities for moderately emissions-intensive trade-exposed activities will

receive 66% of their activity's benchmark emissions intensity as free carbon units. The rate of assistance to industry will be reduced by 1.3% a year. Liquefied Natural Gas projects, although initially qualifying as moderately intensive trade-exposed industries, will be eligible for "top-up" administrative allocations if their assistance rate falls below 50% of their project's actual emissions.

- **Coal-fired Generators Assistance Package:** \$5.5 billion will be allocated over six years to assist emission intensive coal-fired generators (emissions of above 1.0 t CO<sub>2</sub>-e/MWh), in the form of Government loans, cash payments and free carbon units to be issued from 2013 to 2017. Additionally, a **contract for closure program** will offer payment to retire highly emitting 2000 MW facilities that emit greater than 1.2t CO<sub>2</sub>-e/MWh of electricity.
- **Coal Sectors Jobs package:** \$1.26 billion for the first five years of the CPM to entities whose fugitive emissions are more than 0.1t CO<sub>2</sub>-e per tonne of saleable coal produced between 2008-2009. Assistance will be provided to up to 80% of their fugitive emissions that are above the 0.1t CO<sub>2</sub>-e tonne threshold. Approximately 25 Australian mines will be eligible for compensation.

### What are some of the legal implications of the CPM?

Businesses need to be aware of the following legal implications:

- the utility of contract provisions which pass on the direct and indirect costs of the CPM and provide an incentive to minimise these costs;
- allocation of liability under the CPM within corporate groups or within unincorporated joint ventures, including having regard to both statutory and contractual liability, whether liability transfer certificates are required and cost transfer and allocation mechanisms;
- management of CPM liability through the implementation of effective compliance programs;
- entitlement to Government compensation or assistance under the Jobs and Competitiveness Program and availability of grants and tax deductions;
- reworking of existing contracts to introduce clauses regarding the CPM and introduction of new pricing provisions to new contracts to address the future fluctuating value of carbon;
- determination of the CPM's impact on asset values and earnings;
- determination of the CPM's impact on company disclosure obligations;

- whether a financial services licence is required to trade or deal in carbon units, ACCUs or eligible international credits;
- recognition of opportunities to reduce costs and increase in profits through fuel switch, supply switch, increased efficiency, market opportunities; and
- identification of risks associated with insider trading, price gouging, market manipulation, misrepresentations and fraud.

### Who will administer the CPM?

#### Clean Energy Regulator

The primary administration body, responsible for the administration of the CPM as well as the CFI, Renewable Energy Target and NGERs. Credits or units are surrendered to the Clean Energy Regulator, who can demand information from liable entities.

#### Climate Change Authority

An independent body, who will review the operation of the CPM and provide advice to Government on key aspects of the CPM, including the level of emission caps, and other climate change mitigation initiatives and whether national targets are being met.

#### National Greenhouse and Energy Reporting System (NGERS)

A national reporting framework responsible for collecting and disseminating information about greenhouse gas emissions, greenhouse gas projects, and energy use and production of corporations. Under the CPM, liable entities must register to report to NGERs (if they are not already registered) and businesses whose emission levels or energy use exceed mandated thresholds are required to report their activities to the Clean Energy Regulator. NGERs is also the system for calculating emission targets and caps under the CPM.

#### Australian National Registry of Emission Units (ANREU)

An electronic system which ensures accurate accounting of issuance, transfer, acquisition, cancellation, retirement and carrying over of carbon units under the CPM and CFI. It is maintained by the Clean Energy Regulator.

#### The Productivity Commission

An independent research and advisory body, who will review and report on international pollution reduction actions, the Jobs and Competitiveness Program and the fuel excise and taxation regime. The issue of free carbon units under the Jobs and Competitiveness Program will be reviewed by the Productivity Commission every five years.

### Government and Parliament Major policy decisions and legislation

#### Clean Energy Regulator

will administer the:

- Carbon Pricing Mechanism
- Carbon Farming Initiative
- Renewable Energy Target
- National Greenhouse and Energy Reporting Scheme
- Australian National Registry of Emissions Units

#### Climate Change Authority

will review, recommend and track:

- Level of pollution caps
- Operation of the carbon price
- Other climate change mitigation initiatives
- Progress towards pollution reduction targets

#### Productivity Commission

will review and report on:

- International pollution reduction actions
- Jobs and Competitiveness Program
- Fuel excise and taxation regime

## Glossary of Key Terms

Term	Definition
carbon dioxide equivalence (CO <sub>2</sub> -e)	the amount of potential greenhouse gas embodied in an amount of natural gas or a taxable fuel, calculated by multiplying the volume of the gas or fuel by a value specified in the regulations
eligible Australian carbon credit unit (ACCU)	(a) a Kyoto Australian carbon credit unit (within the meaning of the Carbon Credits (Carbon Farming Initiative) Act 2011); or (b) a non Kyoto Australian carbon credit unit (within the meaning of that Act) issued in relation to an eligible offsets project for a reporting period; or (c) an Australian carbon credit unit of a kind specified in the regulations.
eligible emissions unit	(a) a carbon unit; or (b) an eligible international emissions unit; or (c) an eligible Australian carbon credit unit (ACCU).
facility	is an activity, or a series of activities (including ancillary activities), that involve the production of greenhouse gas emissions, the production of energy or the consumption of energy and that form a single undertaking or enterprise or are declared by the Clean Energy Regulator to be a facility.
fugitive emissions	the deliberate but not fully controlled leakage of methane, carbon dioxide and nitrous oxide emissions from the production, processing, transport, storage and distribution of raw fossil fuels (coal, oil and gas).
greenhouse gases (GHG)	those recognised under the Kyoto Protocol: (a) carbon dioxide; or (b) methane; or (c) nitrous oxide; or (d) sulphur hexafluoride; or (e) a hydrofluorocarbon; or (f) a perfluorocarbon. The CPM covers only carbon dioxide, methane, nitrous oxide and perfluorocarbons from aluminium production.
joint venture	an unincorporated enterprise carried on by two or more persons in common, and not in a partnership.
Kyoto Protocol	the Kyoto Protocol to the United Nations Framework Convention on Climate Change, made on 11 December 1997, as amended and in force for Australia.
landfill facility	a facility for the disposal of solid waste as landfill, and includes a facility that is closed for the acceptance of waste.
liability transfer certificate	allows a liable entity to transfer its CPM liability to an entity within the same corporate group or to an unrelated entity that has financial control over the emitting facility.
liquefied natural gas (LNG)	liquefied hydrocarbons recovered from natural gas in separation facilities or processing plants and includes ethane, propane, butane and pentane.
natural gas supplier	a person who supplies natural gas.
operational control of a facility	a corporation or person has operational control over a facility if it has the authority to introduce and implement operational, environmental and health and safety policies for the facility or is declared by the Regulator to have operational control of the facility
scope 1 emissions	the release of a GHG into the atmosphere as a direct result of an activity, or series of activities (including ancillary activities) that constitute the facility.

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