

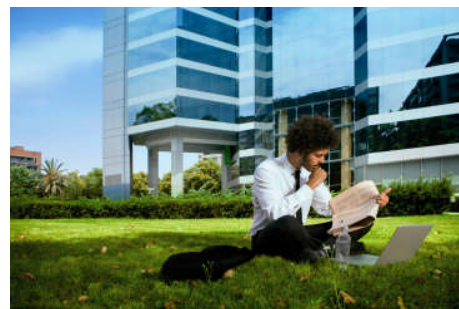
Foundations set for Carbon Pollution Reduction Scheme, but much work to be done

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Sustainability & Climate Change Services

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The White Paper ('white paper') on Australia's Carbon Pollution Reduction Scheme (CPRS) released on 15 December can be seen as the blueprint to one of Australia's most significant economic reforms since the deregulation of the Australian financial markets in the 1980s. It represents a detailed operating framework on scheme design which will now move to draft legislation in the first quarter of 2009.

The white paper highlights the medium-term target range for national emissions and sets out guidance on compensation for industry and complementary supporting measures for households. It follows on from the recently released Garnaut Review, the Federal Government's Green Paper ('green paper'), Treasury modelling and from industry, community and stakeholder consultation.

Specifying indicative target cuts to emissions of five per cent with a possible extension to 15 per cent (in the context of a global agreement) below 2000 levels by 2020, the paper confirms the Government's commitment to reducing emissions to 60 per cent below 2000 levels by 2050. The Federal Opposition has announced its intention to commission an economic review of the scheme and will have the opportunity to debate the proposed legislation in parliament in 2009. It has also been observed that the Greens are unhappy with the emissions trajectories (they would prefer quicker and deeper cuts) and are likely to challenge the Government through the legislative phase.

Developments from the green paper (based on industry consultation) include changes to the rules for eligibility for emissions-intensive trade-exposed (EITE) industries assistance and an increase in the percentage of free permits that will be allocated. In addition, a broader range of businesses will be entitled to free permit allocations, including LNG and petroleum refinement. The Government will also assist coal-fired generators (recognised as Strongly Affected Industries, or SAIs) with \$3.9 billion (nominal) over five years to help compensate for the reduction in asset values of these carbon intensive sectors.

The Government has reinforced its commitment to commence operation of the CPRS from 1 July 2010, with the medium-term emissions target and scheme caps to be established in the first quarter of 2010 after the Copenhagen Conference of the Parties to the United Nations Framework Convention on Climate Change. This creates a tight timeframe to completion of the scheme regulations (including further industry consultation to refine the operation of EITE assistance), the passage of legislation and the preparation of all involved parties to prepare and commence trading in a new market by mid 2010.

Key points

- The white paper builds on detail from the green paper on the operation of the CPRS, due to start on 1 July 2010.
- The scheme will include all greenhouse gases included under the Kyoto Protocol.
- Emissions from stationary energy, industrial processes, waste and fugitive emissions from oil and gas production will be covered from the start of the scheme.
- The scheme will include around 75 per cent of Australia's emissions and involve mandatory obligations for around 1000 entities.
- The Government will include reforestation in the scheme from commencement on a voluntary basis.
- The Government has set a medium-term target to reduce emissions by five per cent below 2000 levels by 2020 with the possibility of extending this target to 15 per cent if all major economies commit to substantially restraining emissions and advanced economies take on reductions comparable to Australia.
- The white paper estimates a price of \$25 per permit at the outset of the CPRS.
- A price cap per permit has been set for five years, commencing at \$40 per permit escalating at five per cent per annum plus CPI.
- The eligibility thresholds to qualify as an EITE have been reduced and affected industries will receive a higher than expected 25 per cent of available permits in the first year, rising to about 45 per cent by 2020. The two thresholds are in the form of t CO₂-e /\$m rev and the newly introduced value-add threshold.
- The auctioning of permits is expected to raise \$11.5 billion in 2010-11, with \$4.3 billion to be spent on industry assistance measures with the primary aim of reducing 'carbon leakage'.
- EITE and SAI groups will need to collaborate and potentially share commercially sensitive information with the Government to provide extensive, verified economic and emissions data in order to qualify for compensation.
- There are instances where the CPRS will apply in a different way to NGERs.
- Emitters will be required to acquire and acquit one emission permit (AEU) for each tonne of carbon dioxide equivalent (t CO₂-e) emitted.

Questions business leaders should be asking

CEO

- How do I demonstrate compliance with the existing emissions reporting as well addressing the impacts/opportunities for my business from the emerging trading scheme?
- Do I need to stress test our longer-term planning against potential regulatory and market scenarios?
- Have I included the potential impacts of the CPRS in assessing my future strategic risks?

CFO

- Is the cost base and competitive position of my company likely to be impacted by emissions trading, and if so how can I incorporate a carbon management strategy into my overall corporate strategy?
- Can we identify and cost internal abatement opportunities to reduce our emissions and do we have an appropriate emissions measurement and reporting system implemented to assess these abatements and our overall emissions for compliance purposes?
- What process level impacts do I need to consider (e.g. financial accounting for permits and emissions, contracts and market instruments, the tax treatment of trading and assurance arrangements)?

NED

- What is the possible long-term CPRS impact on shareholder value and profitability now that the Australian government's planned response to climate change is more certain?
- What is the board of directors' response to the CPRS and how do the company's climate change and sustainability reporting and communications impact investor decision making?

Implications

Accounting for assets and liabilities arising directly from the CPRS

Consistent with the views expressed within the green paper, accounting for assets and liabilities arising directly from the CPRS will be determined by the requirements of IFRS as developed by the International Accounting Standards Board (IASB) and issued by the Australian Accounting Standards Board (AASB). An exposure draft on accounting for emissions trading schemes is due to be issued by the IASB in late 2009.

Assurance requirements under the CPRS

The white paper confirmed the Government's position that pre-submission assurance over greenhouse gas emission reports will be required for all large emitters (over 125,000 t CO₂-e per annum). In addition, the paper flagged an additional assurance requirement for entities seeking assistance under the EITE assistance program. This requirement will be outlined further in the EITE guidance paper to be released in early 2009. The white paper suggests the data required to be submitted by entities seeking assistance under this program (emissions, revenue, production and trade/exports) will need to be assured by a third-party auditor for a period of up to four and a half years (depending on the data category).

Impairment considerations at 31 December 2008

All entities should carefully consider the accounting implications of the CPRS on their business.

For entities likely to qualify for SAI and EITE assistance and other large emitters, the requirements of the CPRS may have a direct and significant impact on future business cash flows and could potentially trigger an impairment indicator under AASB 136 Impairment of Assets. An impairment indicator would require entities to reassess the recoverable amount of relevant assets to determine whether any impairment write-downs are required. Entities with goodwill and indefinite life intangible assets may also need to factor the impact of the CPRS in their impairment calculations when considering the recoverable amount of these assets as part of the annual impairment test required.

While the CPRS is not fully finalised, the white paper provides additional information on the proposed design of the scheme and reiterates 1 July 2010 for its introduction. As such, entities should consider whether there is sufficient clarity and certainty in the white paper as it relates to their operations, to reliably quantify the impact on cashflows for their business. Large emitters should use the details provided by the white paper to develop their understanding of the potential financial impact of CPRS on their business.

The impact of the CPRS on future cashflows and operations will vary depending on individual circumstances such as the emissions intensity of a company's operations, quantum of emissions permits likely required to acquit obligations under CPRS, the expected level of compensation available and ability to pass through higher costs to customers.

Whilst the white paper clarifies and builds upon the details on the scheme provided in the green paper, the full impact on large emitters and the indirect flow-on effects to the wider economy may not be clear until the legislation is closer to being finalised. Therefore, many entities may still find it difficult to understand the full implications of the CPRS on their business' future cash flows.

Regardless of whether entities understand the full implications of the CPRS, entities with a 31 December financial year end that will be significantly affected should explain the potential impact it will have on their future results and disclose the key assumptions used in impairment tests, including an explanation of whether the proposed CPRS has been factored into the impairment calculation, and if so, how.

Legal

Permits are to be treated as personal property. They will be marked with a 'vintage' but will not have an expiry date. They can be surrendered only once. The white paper also sets out numerous other characteristics, such as no restrictions on foreign ownership and that there will be no provision for people to exit contracts where they might be detrimentally affected by the increased carbon impost.

Tax

The tax treatment outlined in the white paper is broadly consistent with the preferred position as set out in the green paper. The Government has, however, given consideration to the various submissions made by interested bodies and this has been reflected in the revised tax treatment relating to administratively allocated permits issued to relevant industries. The revised tax treatment will be welcomed especially by EITE companies.

The intended revenue raised by the Government from selling permits is \$11.5 billion in just the first year, with industry funding this cashflow. Some of the tax policies adopted mean that industry will also bear an additional cashflow burden through deferred tax deductions and GST payments.

Companies will have the options of valuing the permits on hand at year-end at either cost or market value. There will be a one-off opportunity to make one change to the election in the first five years from the commencement of the scheme. Using the cost valuation method will mean that the tax outcome will mirror the cash outlay, but this will most likely cause a difference to the approach adopted for accounting purposes. Using the market value method will accelerate the income being brought to account for tax purposes, if the market price of permits is increasing. Alternatively, this could result in accelerated deductions if the market price of permits is declining.

Free permits issued to coal-fired generators on hand at the end of the year received (not surrendered) will be assessable at either the cost or market value method, whichever method is adopted by the entity.

Free permits issued to EITE entities will be given a zero value until the income year before the last surrender date for the emissions year for which they were issued. After that time, they will be valued at either cost or market value method, whichever method is adopted by the company. Cost in these cases will be the market value on the date of issue.

Emitters that do not surrender sufficient permits to cover their emission levels will be subject to a non-deductible penalty and will also be required to make good any shortfall by purchasing and surrendering permits to the scheme regulator. The cost of these permits will be tax deductible. Businesses should therefore ensure that sufficient permits are surrendered in respect of their emission levels, given the requirement to make good any shortfall in addition to the penalty imposed for non-compliance.

Key features of the scheme

Targets and trajectories

The scheme is a cap and trade model, designed to impose a cost on carbon (as a pollutant). The price of permits will be set by the market and will be strongly affected by the targets and trajectories set out in the white paper.

The near-term indicative trajectory for national emissions is 109 per cent of 2000 levels for the 2010-11 year, falling to 107 per cent of 2000 levels for 2012-13. Australia's long-term commitment remains at reducing emissions to 60 per cent below 2000 levels by 2050.

The Government's goal is to reduce emissions to 5-15 per cent below 2000 levels by 2020, with the five per cent target being unconditional and the 15 per cent to be pursued if all major economies commit to substantially restraining emissions and advanced economies take on reductions comparable to Australia. The white paper does not specify what would be considered an appropriate global agreement.

The five per cent medium-term target represents a 27 per cent reduction in per capita emissions and is in line with per capita emissions reductions targets adopted by the EU and the UK.

Which sectors and gases are covered?

The scheme is designed to cover 75 per cent of Australia's emissions and creates mandatory obligations for around 1,000 companies.

Emissions from stationary energy, transport, industrial processes, waste, and fugitive emissions from oil and gas production will be covered from the start of the scheme.

Agriculture may be added after 2015, with a decision to be made in 2013. Reforestation will be included in the scheme on a voluntary basis.

The white paper also confirms the inclusion of all the gases included under the Kyoto Protocol (CO₂, CH₄, N₂O, SF₆, HFCs and PFCs).

Sale and pricing of permits

Emitters will be required to acquire and acquit one emission permit (AEU) for each tonne of carbon dioxide equivalent (t CO₂-e) emitted. Permits will be sold through 12 simultaneous, ascending clock auctions each financial year – an increase on the number anticipated after the green paper. The first auction is to occur in 2010 before the scheme starts. The Government will also hold mock auctions to familiarise participants with carbon trading prior to the launch of the scheme.

The price of permits (the 'carbon price') will be set in the market. However, the white paper forecasts prices to be \$25 in 2010-11. This is close to Treasury modelling at the lower end of the medium target range assuming efficient global action to stabilise greenhouse gas concentrations at 550 ppm suggests an initial emissions price of around \$23 per tonne CO₂-e.

The white paper also outlines measures to reduce price volatility and speculation, including:

- unlimited access to international abatement through the Kyoto mechanisms (certified emission reductions)
- a transitional cap on the price of permits of \$40 (rising at five per cent per annum plus CPI)
- unlimited banking of permits
- limited borrowing of permits of up to five per cent from next years vintage

Bidders will also be restricted to parcel sizes of no more than 25 per cent of the total number of permits at each auction, preventing hoarding. Further, any entity will be eligible to trade and cancel permits – not just the major emitters that are liable under the CPRS. The white paper also proposes that a relatively large amount of information about trading transactions and entities is published to ensure market transparency.

Permits will have the status of 'financial products', facilitating ASIC oversight (e.g. to investigate or prosecute manipulation in the carbon market) thereby aligning them with other tradeable instruments.

Carbon credits

The creation of Australian-based carbon credits (as opposed to allowances) will be limited due to the broad sectoral coverage of the scheme. In practice, this limits the scope to pursue credit creation opportunities for compliance purposes. Domestic abatement may still be generated from emission reduction projects within sectors not covered under the CPRS and utilised for voluntary offsetting rather than compliance obligations.

International linkages

The white paper promotes linkages between the proposed Australian scheme and international carbon markets. The Government will allow entities to use eligible Kyoto units for compliance (CDM) and, in a departure from the green paper, specifies no restrictions on the quantity of Kyoto units that may be used for compliance purposes. The export of permits will not be allowed.

A minimum of five years' notice will be given to signal any change to international linking.

Governance and compliance monitoring

As proposed in the green paper, reporting and compliance under the Scheme will be based on the *National Greenhouse and Energy Reporting Act 2007* (NGERS). Liable entities (either because they have obligations as an upstream supplier or because they have operational control over a facility with Scope 1 emissions in excess of 25,000 t CO₂-e) will need to measure, calculate and report emissions in line with the NGERS framework.

There are instances where the CPRS will apply in a different way to NGERS. For example, in certain circumstances entities with financial control over a facility (as opposed to the usual operational control test) can assume the liability for a facility and subsidiaries can also be nominated as liable entities (previously the liability would rest with the controlling corporation as determined under NGERS).

The scheme will apply to federal, state and local government agencies which have operational control over facilities in excess of facility thresholds.

The white paper prescribes that electricity generators, underground mines and entities reporting PFCs must use higher order measures; that is methods 2-4 of the *National Greenhouse and Energy Reporting (Measurement) Determination 2008*.

Who will receive compensation?

The Government has expanded support for companies that are emissions intensive, trade exposed (EITE) and strongly affected industries (SAIs).

The white paper follows the principles set out in the green paper but specifies lower threshold levels of emissions intensity per million dollars of revenue and introduces an alternative

route for eligibility based on emissions intensity per 'value-add', a term which continues to be defined but relates to revenue less the cost of the most significant non-labour, non-capital inputs (see table).

The paper also expands the type of emissions involved such that new activities such as LNG production and petroleum refining are now likely to be included.

Threshold levels

	tCO ₂ -e/\$m revenue	or	tCO ₂ -e/\$m value-add
90 per cent assistance	2,000		6,000
60 per cent assistance	1,000		3,000

EITEs will be allocated approximately 25 per cent of available permits 2010, rising to around 45 per cent by 2025 as the growth of EITE industries and the inclusion of agriculture from 2015 are taken into account. However, the Government will reduce the rates of EITE assistance year-on-year by approximately one per cent to reflect improvements in national carbon productivity.

SAIs, which are limited to coal-fired power generators, will receive approximately \$3.9 billion over five years through a fixed allocation of up to 130.7 million permits. This equates roughly to 13 per cent of total electricity sector emissions.

While both groups will welcome the assistance, they face a significant administrative burden in the next 6-12 months as the Government seeks additional detailed, robust and credible data to finalise the scheme and to prove their eligibility.

An EITE guidance paper is due to be released in early 2009. Entities seeking EITE assistance will need to submit independent third-party assured data to the Department of Climate Change before the middle of 2009.

SAIs will be required to apply to the scheme regulator within 90 days of commencement of the CPRS legislation in order to prove eligibility and provide information relevant to determining the amount of assistance they should receive.

What is still to come?

The white paper indicates that the draft CPRS legislation (originally anticipated to be released with the white paper) and proposed amendments to the NGERS will be made available in late February 2009 for comment, with the intention to have the bill(s) introduced into parliament for the 2009 winter session.

The Government also needs to release:

- Further guidance around the data requirements of the EITE assistance program.
- Information around complementary measures, such as how money will be invested into education and R&D, and further detail around the National Renewable Energy Target.
- Amendments to the GST laws to characterise pollution permits and eligible Kyoto units.
- The External Audit Legislative Instrument which will set out the assurance framework for the NGERS and CPRS.
- Draft carbon offset standard for voluntary action beyond compliance.

Conclusion

The white paper provides business with more of the specific information required to prepare for the introduction of carbon trading in Australia. The complex and far-reaching nature of the scheme underlines the enormous challenge facing the Government to introduce the scheme by July 2010. While many specifics remain to be finalised, companies are now in a better position to analyse the threats and opportunities that Australia's climate change response presents to their operations. They have also been set a tight timeframe in which to act.

Companies should mobilise now if they have not already to provide clarity around their obligations under EEO, NGERs and CPRS. This takes the form of compliance and cost management as well as understanding of how to benefit from the opportunities presented in this framework.

Transition support funds

The Government has committed to invest the money raised through the CPRS to help Australian businesses and households adjust to the new scheme. One of the mechanisms by which to do this is through the Climate Change Action Fund (CCAF), which is designed to assist businesses, community sector organisations, workers, regions and communities to transition into an operating environment that includes a price on carbon.

Some \$2.15 billion will be invested into the CCAF over a five-year period from 2008-09. The CCAF covers the supply of information to business and community groups, investment in energy efficiency and low emissions technologies, structural adjustment provisions for workers and communities and adjustment funding for the coal sector.

The Government has also said its previously announced \$500 million Renewable Energy Fund will be spent over 18 months from 2008-10, instead of a planned six years.

CPRS timeline

2009	
Q1	Government releases guidance paper on data requirements of the EITE assistance program
	Entities engaged in potential EITE activities submit data requested in guidance paper
	Public release of exposure draft CPRS legislation
Q2	Exposure draft legislation consultation period closes
	CPRS Bill and NGERs consequential amendments introduced into parliament
	Public release of key draft CPRS regulations (including activities covered by EITE)
Q3	Government aims to achieve passage of the CPRS Bill through parliament
	Registration under NGERs
	Applications under the SAI assistance program to be made to the regulator
Q4	Private entities able to open national registry accounts for Kyoto units
	Submission of first year reporting under NGERs
	CPRS regulations and legislative instruments made and tabled in parliament following passage of Bill
United Nations Climate Change Conference in Copenhagen, Denmark (COP 15)	
2010	
Q1	Government to announce:
	<ul style="list-style-type: none"> extension of national emissions trajectory up to 2014-15 scheme caps for first five years of Scheme (2010-11 to 2014-15) 10 years of Scheme gateways after 2014-15 approach for expanding cap to accommodate increases in coverage
	National registry operational with CPRS functions
	First auction of permits
Q1 & Q2	First auction of permits
Q3	Start of first CPRS compliance year
	Applications under the EITE assistance program made to the regulator and subsequent allocation of permits to EITE eligible entities
Q4	Submission of second year reporting under NGERs
2011	
Q2	End of first CPRS compliance year
Q4	Deadline for liable entities to submit emissions reports through the NGERs including audited information for large emitters
	Deadline for surrender of eligible compliance permits for first compliance year
2013	
	Government to announce final decisions on coverage of agriculture
	A decision to allow for the sale and transfer of Australian carbon pollution permits internationally
2015	
	Possible inclusion of agriculture in the Scheme

Key:

Government action	Company action	NGERS deadline

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