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The Carbon Pollution Reduction Scheme – what is it and how will it affect developers?

“Climate change presents a risk to the survival of the human race and other species ... it is, a deadly serious issue. It has been increasingly under public scrutiny for some years”.

Biscoe J in *Walker v Minister for Planning* (2007) 157 LGERA 124 at 161

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Although the draft legislation for the Carbon Pollution Reduction Scheme has some way to go before it is law, practitioners should be aware of the scheme’s structure, assistance to certain industry sectors, and the impacts it is expected to have on the property development sector.

Background

There is no doubt that climate change due to greenhouse gas (**GHG**) emissions is now a global problem.

One of the Federal Government’s responses to this global problem is the introduction of a new national ‘cap and trade’ emissions scheme called the Carbon Pollution Reduction Scheme (**CPRS**). On 14 May 2009 the Federal Government introduced the draft legislation for the CPRS to Parliament which will commence on 1 July 2011 instead of the previously announced commencement date of 1 July 2010 in a bid to manage the on-going impacts of the global recession. This draft legislation has some distance to go before it is finalised, with strong criticism directed at the Federal Government for targets considered too low, the availability of free permits for big polluters and businesses facing an increase in their operating costs.

The introduction of the legislation followed the release of the Government’s White Paper on the CPRS in December 2008. The White Paper’s objective was to set out the Government’s policy regarding the structure of the CPRS, including the GHG reduction targets under it. The objective of the CPRS is to achieve reductions in Australia’s GHG emissions in a way that meets the Government’s target of reducing GHG emissions to 60% below year 2000 levels by 2050.

Coverage under the CPRS

The aim is for the CPRS to apply to the larger GHG emitters, being facilities that have direct GHG emissions of 25,000 tonnes or more of carbon dioxide equivalent a year. The GHGs caught under the CPRS are emissions of carbon dioxide, methane, nitrous oxide, sulphur hexafluoride, specified hydrofluorocarbons and specified perfluorocarbons.

GHG emissions from the following sectors will be covered by the CPRS:

- Stationary energy
- Transport
- Industrial processes
- Waste; and
- Fugitive emissions, released in the production and distribution of fossil fuels.

Agriculture will be included in the CPRS at a later date but not before 2015.

GHG emissions in the transport sector will be treated differently from those in the other covered sectors. In the transport sector, the CPRS obligations will be placed on the upstream suppliers of transport fuels rather than on those directly emitting from the use of such fuels.

Increased reduction target for 2020 (if global agreement is reached)

The Federal Government proposes in the draft legislation, an increase of the upper limit of the emissions reduction target for 2020 from a reduction of 15% from 2000 levels as announced in the White Paper to a reduction of 25% from 2000 levels if the world agrees to stabilise levels of CO₂e at 450 parts per million.

The world agreement (to be discussed and scheduled to be determined at international negotiations in Copenhagen in December this year) must meet the following conditions in order for the 25% reduction target to be adopted under the CPRS:

- comprehensive coverage of gases, sources and sectors including the forest and land sectors;
- a clear global trajectory, where the sum of all economies' commitments is to stabilise emissions of CO₂e at 450 parts per million or lower and with a nominated early deadline year for peak global emissions no later than 2020;
- advanced economy reductions of at least 25% below 1990 levels by 2020;
- major developing economies committing to slow growth and then reduce their absolute levels of emissions over time, with a collective reduction of at least 20% below business-as-usual by 2020 and a nominated peak year for individual major developing economies; and
- global action which mobilises greater financial resources, including from major developing economies, and results in fully functional global carbon markets.

Up to 5 percentage points of the 25% reduction target could be met by Government purchase of international credits, such as avoided deforestation credits, using CPRS revenue no earlier than 2015.

Scheme caps and permits

The CPRS will set a national annual cap on GHG emissions from the covered sectors. The Federal Government will outline the caps at least 5 years in advance with the caps for the first 5 years to be announced in 2010.

Liable entities will need to acquire and surrender a permit, known as an Australian Emissions Unit (AEU), for every tonne of GHG emissions generated in a financial year. The total number of AEU's available for that year will be equal to the national cap. If, for example, the cap limits emissions to 200 million tonnes of carbon dioxide equivalent in that year, there will be 200 million AEU's issued for that year.

AEUs will be tradeable and will not have an expiry date (allowing AEUs acquired in one year to be surrendered in later years). A one year fixed AEU price will apply from 1 July 2011 to 30 June 2012, with each AEU costing \$10 (for a tonne of CO₂e) instead of the previously anticipated cost of \$25/t CO₂e. These AEUs can only be surrendered for emissions during the 2011/12 financial year. The Government intends to auction AEUs on a monthly basis. Initially, approximately 70% of AEUs will be auctioned with the rest to be allocated as free AEUs (see further discussion below).

Application of the CPRS to developers

The CPRS is unlikely to apply directly to developers given the sectors covered and the GHG emission thresholds. However, the CPRS may have a significant impact on development projects. The most likely impact will be increased development costs and uncertainty surrounding those increased costs.

Effect on building product prices

The producers of building products such as cement, steel, bricks, glass and aluminium are likely to be required to hold AEUs. A number of these producers will be entitled to free AEUs as emissions-intensive trade-exposed (**EITE**) industries, such assistance being intended to dissuade such producers from moving their production off-shore. To qualify for EITE assistance:

- the combined value of exports and imports for the relevant product from all producers must exceed 10% of the value of domestic production from all producers in any year from 2004/05 to 2007/08 (or there must be a demonstrated inability to increase costs due to the potential for international competition); and
- the emissions intensity of the activity producing the product on an industry-wide weighted average must exceed 1,000 tonnes of CO₂e per million dollars of revenue (or exceed 3,000 tonnes of CO₂e per million dollars of value added).

The rate of EITE assistance will be:

- free AEUs for 60% of the GHG emissions of the liable entity (subject to adjustment to accord with industry averages) where the emissions intensity is between 1,000t CO₂e/\$ million revenue (or 3,000t CO₂e/\$ million value added) and 1,999t CO₂e/\$ million revenue (or 5,999t CO₂e/\$ million value added); or
- free AEUs for 90% of the GHG emissions of the liable entity (subject to adjustment to accord with industry averages) where the emissions intensity is equal to or greater than 2,000t CO₂e/\$ million revenue (or 6,000t CO₂e/\$ million value added).

In May 2009 the Federal Government announced extra EITE assistance will be provided with a Global Recession Buffer (**GRB**) applying to the EITE allocation baselines at a rate of:

- 5% for EITE activities receiving the 90% assistance rate; and
- 10% for EITE activities receiving the 60% assistance rate.

For example, for 'Activity A' which is eligible to receive assistance at the 90% rate, the free AEU (per unit output) incorporating an extra 5% GRB will be:

Industry average emissions baseline for 'Activity A' x GRB of 1.05 x Assistance rate of 0.9

The GRB will operate for the first 5 years of the CPRS. Its future extension will be considered as part of the EITE assistance review for the first 5 years of the CPRS. EITE assistance will be reduced by 1.3% per year and will be reviewed at 5 yearly intervals.

"If increased electricity prices do occur as a result of the introduction of the CPRS, this is likely to result in a renewed focus on the energy efficiency of buildings due to the increased cost of outgoings."

As a consequence of the complexity of the eligibility rules and rates of EITE assistance, developers are likely to face uncertainty regarding the price of building products whose producers are required to hold AEU's under the CPRS. It is possible that tenderers for building projects will not be willing to fix the price for such products and instead seek to adjust these prices once the impact of the CPRS on prices is known.

Effect on electricity prices

The CPRS will require electricity generators to hold AEU's for those generation facilities whose annual direct GHG emissions are equal to or exceed 25,000t CO₂e. As the majority of electricity generated in New South Wales is from coal-fired generators, those electricity generators in NSW are likely to need to hold AEU's. The Government will provide free AEU's to coal-fired electricity generators until July 2016 (under an arrangement to be known as the Electricity Sector Adjustment Scheme (**ESAS**)). After that date, those generators will be required to purchase all AEU's required to meet their obligations under the CPRS.

In order to be eligible for ESAS assistance, the emissions intensity of the generator between 1 July 2004 and 30 June 2007 must exceed 0.86 tonnes of CO₂e per megawatt-hour of electricity generated (with provision to be made for generators not operational by 1 July 2004). The level of ESAS assistance will be capped at 26.14 million AEU's per year over the 5 year life of the ESAS. An eligible generator's proportion of that assistance will be determined by multiplying the result of the following formula by the annual cap:

$$\frac{\text{Emissions intensity of generator exceeding } 0.86\text{t CO}_2\text{e/ GWh} \times \text{output of generator from } 1/7/04 \text{ to } 30/6/07}{\text{Sum of calculation above in formula for all generators}}$$

Sum of calculation above in formula for all generators

The extent to which the ESAS will limit increased electricity prices as a result of the CPRS is unclear. However, it is clear that electricity generated from renewable sources will not need to be priced to include the cost of AEU's as these forms of generation will not be subject to the CPRS. The possible impact of the CPRS on electricity prices for electricity generated from coal-fired generators should cause developers to further consider the attractiveness of 'greener' sources of electricity such as GreenPower.

If increased electricity prices do occur as a result of the introduction of the CPRS, this is likely to result in a renewed focus on the energy efficiency of buildings due to the increased cost of outgoings. Consequently, developers may see even more potential tenants seeking to occupy those buildings which have or are targeting 4 to 5 star NABERS Energy ratings. Building owners will also need to consider whether net or gross leases are more suitable in an environment where electricity prices are tipped to rise under the CPRS.

Effect on costs of waste disposal

GHG emissions from landfill facilities will be covered by the CPRS (excluding those from facilities which closed prior to 30 June 2008). However 'legacy' emissions from waste deposited in landfills prior to 1 July 2008 will not be included in the CPRS.

While the general threshold for liability under the CPRS is 25,000t CO₂e annually for a facility, landfill facilities are subject to a lower threshold of 10,000t CO₂e where a facility is operating in proximity to another operating landfill facility. The Federal Government is yet to announce the proximity but an example distance of 80 kilometres was used in the White Paper. The threshold will rise to 25,000t CO₂e per year once the landfill facility has been closed for 10 years.

As no Government assistance is provided to the waste industry under the CPRS, the costs of waste disposal are likely to increase (particularly for those substances which contribute to GHG emissions from landfill facilities). The inclusion of emissions from waste deposited since 1 July 2008 and the inclusion of 'legacy' emissions from 2018 mean that landfill operators will have to recover the cost of holding AEU's for these emissions from current users of their facilities.

Effect on transport costs

As outlined above, upstream fuel suppliers will be liable to meet the CPRS obligations in the transport sector. Accordingly, suppliers incurring costs to meet those obligations, being primarily the cost of holding AEU's, will seek to recover those costs by increasing the price at which the relevant fuel is supplied. However, the Federal Government has agreed to cut fuel taxes on a 'cent-for-cent' basis until July 2014 to offset the price impact on fuel of the introduction of the CPRS. The Federal Government will review this adjustment mechanism at the end of this 3 year period.

Conclusion

While the final form of the legislation may differ from that proposed in the White Paper and included in the draft legislation, lawyers who have developers as clients should now be advising their clients to prepare for the increased costs likely to arise from the implementation of the CPRS.