The future of the Carbon Pricing Mechanism
Managing uncertainty
Contents

04  Key points
05  The current political context
05  The politics and process of repealing the CPM
07  Amending the CPM – opportunities and obstacles
10  Implications for business and carbon markets of CPM repeal or amendment
13  The Direct Action alternative to the CPM
14  Developing a strategy for managing uncertainty
17  The science
18  How Norton Rose can assist
An analysis of the risks, implications and strategies for Australian business and carbon market participants in the lead up to and beyond the 2013 Federal election.

The Australian electorate is fast approaching the latest crossroads on its rollercoaster journey to securing a stable policy, legal and market framework for addressing climate change. With the Liberal-National Coalition (Coalition) repeatedly reaffirming its intent to repeal the “carbon tax” and implement its Direct Action alternative, a change in Government could, in practice, see anything from a radical shift to a subtle rebadging of Australia’s climate change response. With previous false starts and partisan politics fresh in the memory of the business and investment community, all sectors are understandably struggling to make long term decisions given the current uncertainty.

Norton Rose has prepared this analysis to provide Australian business with an understanding of the likely process and timing scenarios for a full repeal of the Carbon Pricing Mechanism (CPM). The analysis also gives consideration to other options that the Coalition may pursue, if full repeal does not ultimately become possible. We also consider what is currently known of the Coalition’s alternative policy for addressing climate change, and conclude with suggestions on strategies that business could pursue both before and after the Election.

Key points

• The future of Australia’s clean energy legislative package and the CPM is likely to be determined by the result of the federal election in September 2013.

• The Coalition has committed to repeal the CPM if it wins the election. The avenues and timelines for achieving this will depend on the make-up of both houses of parliament after the election. It is unlikely that a repeal of the CPM would take effect before the second half of 2014 (which falls during the third compliance year of the CPM).

• If a new Coalition government seeks to amend rather than repeal the CPM, it would need to pass amendment legislation through Parliament which could face similar political and time hurdles to a full repeal.

• A repeal or amendment of the CPM is likely to have significant implications for liable entities, funding arrangements under assistance packages, carbon markets (domestic and international), carbon transactions, households and the wider business community.

• The Coalition’s alternative climate change policy is currently outlined in its Direct Action Plan. The principal plank of Direct Action is the establishment of an Emissions Reduction Fund, which would be used to purchase abatement. It is expected that the Carbon Farming Initiative would remain under Direct Action, but its role and form in this context remains unclear.

• Businesses should ensure they have strategic plans in place to address the uncertainty created by the upcoming election and which can respond to either election result. This should include short term considerations under existing contracts and investment strategies, as well as taking a longer term view on the need (or otherwise) for their business to take strong action against climate change in the most cost effective manner.

• In the meantime, businesses should ensure that they continue to comply with existing legal obligations under the clean energy legislative package and in particular, upcoming compliance requirements under the CPM.
The current political context

The federal election is scheduled to take place on 14 September 2013 (Election) and the political dialogue between now and the Election will have a strong focus on the Coalition’s and Labor’s conflicting approaches to the policy response to address climate change.

The future of the clean energy legislative package and the CPM is largely dependent upon the outcome of the Election. The Coalition has committed itself to repealing the legislation which enacted the CPM and the Leader of the Opposition, Tony Abbott, has labelled the Election a “referendum on the carbon tax”. This position was reinforced in the Coalition’s manifesto of January 2013, which confirmed that the Coalition will act “immediately to abolish the carbon tax” and that “legislation to repeal the carbon tax will be the first piece of legislation the Coalition will introduce”. Labor, unsurprisingly, remains loyal to the CPM, and The Hon Greg Combet, Minister for Climate Change and Energy Efficiency, has committed Labor to the position of refusing to ever support an Abbott government’s attempt to repeal the CPM.

These opposing policy positions are likely to have greater ramifications than just the potential repeal of the CPM. Another example of the likely fallout from a change in government is the Coalition’s stated intention to abolish the Clean Energy Finance Corporation (CEFC). A recent letter from The Hon Andrew Robb, Shadow Minister for Finance, Deregulation and Debt Reduction and The Hon Greg Hunt, Shadow Minister for Climate Action, Environment and Heritage (Shadow Minister) to the CEFC requested that the CEFC make no funding commitments prior to the Election on the basis it will reject those commitments. This is despite the fact the CEFC is able to lawfully enter into contracts now and start spending its $2billion per year of funding from 1 July.

The politics and process of repealing the CPM

Given that the leader of the Coalition, Tony Abbott has made a “pledge in blood” to repeal the CPM, it is worth considering whether, and if so, how this pledge will be achieved. In our view, repealing the CPM is likely to be more difficult in practice than in theory.

As has been widely identified, there are several parliamentary avenues for the Coalition to potentially achieve a repeal of the legislation which establishes the CPM. All options assume that the Coalition is successful at the Election:

• The Coalition wins a majority in both the House of Representatives and the Senate.

• The Coalition wins a majority in the House of Representatives, and is able to achieve a majority in the Senate with the support of cross-benchers (i.e. Independents, such as Senator Madigan and Senator Xenophon).

• The Coalition wins a majority in the House of Representatives but fails to obtain control of the Senate, however Labor does not oppose the legislation repealing the CPM on the basis of the Coalition’s election mandate.

• The Coalition holds the majority in the House of Representatives but fails to obtain control of the Senate, however Labor does not oppose the legislation repealing the CPM on the basis of the Coalition’s election mandate.

The Coalition has indicated that if it wins Government it will have a repeal bill (Repeal Bill) ready for consideration by Parliament within one month of “day one”, presumably meaning 16 September 2013. Assuming the Coalition sticks to this deadline, the Repeal Bill would be ready on 16 October 2013 and could be introduced to Parliament on 28 October 2013.

1 Tony Abbott, Address to the National Press Club of Australia, Canberra (31 January 2013).
6 “Day one” would involve the Coalition instructing the Department of Prime Minister and Cabinet to draft the Repeal Bill legislation and to have the legislation ready and approved by Cabinet within one month.
7 28 October 2013 is the first date after 16 September 2013 when both the House of Representatives and Senate will sit.
How quickly could repeal happen?

- Although the Repeal Bill could, in theory, be passed in both Houses of Parliament on 28 October 2013, it is more likely to take several months given the controversial nature of the CPM, the complexity of the clean energy legislative package that underpins it, and the significant impact that repeal would have.

- There are also likely to be a number of procedural steps in the parliamentary process which slow down its passage. These include possible referral to a standing or select committee, debate on the Repeal Bill, the moving of amendments, and time delays due to standing orders. These steps can be suspended or bypassed in certain circumstances, which could help to expedite the process.

- The Coalition will not have control of the Senate at this time. Even if the half Senate election (on 14 September 2013) results in the Coalition gaining control of the Senate, this does not take effect until the newly elected senators take their seats on 1 July 2014 after half of the existing senators retire on 30 June 2014.

Therefore, the only scenario in which the Repeal Bill could be passed before the end of the 2013/2014 CPM compliance year is if Labor accepts that a new Coalition government has a mandate to repeal the CPM and agrees to support its passage. The Gillard government currently maintains that it will not agree to this and a change to this position, even in the event of a landslide election defeat, seems like an unlikely scenario.

What is the more likely timing?

In our view, a more likely scenario if the Coalition wins control of both the House and the Senate is that it will have to wait until the new Senate is formed before commencing the legislative process to introduce the Repeal Bill. This would mean that the CPM would remain in place until at least mid-2014.

In either scenario we are of the view that it is likely to take several months for any repeal to become effective because there would need to be a transitional period put in place to allow businesses to get their affairs in order given the significant impact of a repeal. In particular, in our view it may be difficult for the Coalition to unwind the CPM midway during a compliance year.

The double dissolution option

If the Coalition does not gain control of the Senate (or have the support of the cross benchers) and Labor refuses to support the Repeal Bill after the Election, the remaining scenario for repeal is via a double dissolution election.

In this scenario, if the Senate rejects the Repeal Bill, the Coalition would need to wait three months before it could initiate a similar bill on the same terms. If this occurred and the Senate rejects it again, the Coalition may call a double dissolution. Although this step could have significant potential ramifications (i.e. one result being the Coalition losing the double dissolution election), the Coalition have indicated that they are prepared to use this option.

There are varying views on the likelihood of this occurring. On one view, it could be seen as the ultimate test of the Coalition’s policy resolve to scrap the CPM and more broadly the concept of an emissions trading scheme in Australia. However, one would assume that the Coalition would have to be very confident of the result to expose itself in this way. It is also worth noting that double dissolutions are rare and history reads of governments that do go to a double dissolution being worse off.

The fastest possible time frame for repeal via the double dissolution avenue is likely to be approximately 8-9 months from the Election, but it could potentially extend several months longer than this. This would mean that a repeal would be unlikely to take place until some time during the 2014/2015 CPM compliance year. The question then becomes whether the Repeal Bill could effectively cancel that compliance year or whether it would still need to take place, in which case the CPM will have been in place for three years and the “tax” component of the scheme will be over. In this scenario, one would query whether there will still be the same impetus for the Coalition to push on with a repeal, given that both business and the community are likely to have adapted to living with a “price on carbon” and the Coalition may not have the same groundswell of opposition that was in place before the CPM’s introduction.

8 We refer to Deutsche Bank’s Special Report entitled “If the Coalition wins, how long would it take to repeal the carbon price?” dated 7 May 2012, for an excellent description of how the Senate works and its current composition.

9 There have only been 6 double dissolutions in the history of Australian politics, the last one being in 1987. Of these 6 elections, only one resulted in the government winning the Senate and passing the legislation in issue. Once again, we refer to the excellent Special Report prepared by Deutsche Bank in May 2012 (see footnote 8 above)

10 Andrew Macintosh, Abbott has pledged to repeal the carbon tax – but could it be done?, The Conversation (2 July 2012), http://theconversation.edu.au/abbott-has-pledged-to-repeal-the-carbon-tax-but-could-it-be-done-7986
Interestingly, in the early days of Tony Abbott's leadership there was significant focus on the “great big new tax” slogan, and if this formula had been maintained, the easiest way for the Coalition to have presented a “reversing” of this tax would have been to drop the fixed price period of the CPM and move straight to the pure emissions trading stage. However, more recently, the Coalition has confirmed that there will never be an emissions trading scheme under their Government and so they appear to have ruled out this option.

Amending the CPM – opportunities and obstacles

The challenges that the Coalition faces with regard to the politics and process of repealing the CPM may mean that a full repeal is not politically possible. It is feasible that Tony Abbott may find the uncertainty inherent within the double dissolution less appealing as Prime Minister, than it was whilst he was leader of the Opposition. Instead, the Coalition may look at the option of amending or partially unwinding the CPM so that it no longer operates as it was originally designed to.

There have been a number of mooted options as to how, and even whether, the Coalition could seek to amend the CPM so that it no longer has any legal effect. Key to this analysis is the question of whether the Coalition can amend the CPM through the “backdoor” (i.e. through regulations and legislative instruments) or whether amendments to the *Clean Energy Act 2011* (CE Act) would be required. In the latter scenario, the Coalition would face the same hurdles set out above.

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11 Greg Hunt, appearing on *ABC TV Q&A Show About Nothing* (18 February 2013). In response to a question on whether the Coalition would ever move to some form of emission scheme, Greg Hunt responded “I don’t see it’s ever likely to happen.”
### Possible ways the Coalition could seek to alter or amend the CPM:

<table>
<thead>
<tr>
<th>Option</th>
<th>Description</th>
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<tbody>
<tr>
<td>Removing the fixed price period and moving to flexible pricing before 1 July 2015</td>
<td>This would ensure that the CPM would no longer operate as a “tax” on emissions, but would instead operate as a fully functioning emissions market from an earlier point in time. Now that the CPM has been linked to the European Union Emissions Trading Scheme (EU ETS), and given where the EU ETS allowances are currently trading (under A$7), there may be some momentum to adopt this course of action. However, as mentioned above, notwithstanding the distinction that the Coalition appears to have made when they have described the CPM as a “tax”, more recently they have confirmed that there will be no emissions trading scheme under a Coalition government. In reality, the earliest the Coalition could move from the fixed phase of the CPM to the flexible phase would be 1 July 2014, as the necessary amendment legislation would only get passed during the second year of the CPM. As the charge per unit for carbon units under the fixed charge years (1 July 2012 – 30 June 2015) is set out in the CE Act, the CE Act would need to be amended for this option.</td>
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<tr>
<td>Increasing the CPM liability emissions threshold so that no entities are liable</td>
<td>This option would involve increasing the threshold of liable entities to an arbitrarily high number so that, despite the CPM existing in theory, in practice, no entities would be caught, and the CPM would not function. The current emissions threshold of 25,000 tonnes of carbon dioxide equivalent emissions per year is contained within the CE Act. Accordingly, this option would require an amendment to the CE Act.</td>
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<tr>
<td>Changing the fixed price units to $0</td>
<td>Under this option, the Coalition could seek to ensure that there are no costs associated with the operation of the CPM, by changing the price of units to $0. As set out above, however, the pricing of the fixed price units is contained within the CE Act and to amend these figures, the Coalition would need to amend the CE Act.</td>
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<tr>
<td>Reducing the unit shortfall charge to $0</td>
<td>This option would eliminate the financial penalty for non compliance, and therefore there would be no incentive for liable entities to adhere to the CPM. The detail of the shortfall charge is set out in the CE Act. In addition, the Clean Energy (Unit Shortfall Charge – General) Act 2011 sets out a standard formula for the imposition of the unit shortfall charge. If during the flexible years of the CPM, regulations are not enacted, then the Clean Energy (Unit Shortfall Charge – General) Act 2011 sets out a default figure for the unit shortfall charge. Again, any attempt to eliminate the unit shortfall charge would need to be made by primary legislation.</td>
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<tr>
<td>Over supplying carbon allowances</td>
<td>The Coalition could attempt to set the carbon pollution cap at an arbitrarily high number, which would lead the market to become oversupplied with allowances with the result that the carbon price would eventually be pushed down to $0. The carbon pollution cap is required to be set out in regulations, which must be made no later than 31 May 2014. However, any regulations proposed by the Coalition to implement this option, would likely be blocked by the Senate, as they would be contrary to the objectives of the CE Act. Additionally, under the CE Act, a default carbon pollution cap for 2015-2016 and a default carbon pollution cap for flexible charge years is set out, so a carbon pollution cap will come into operation, regardless of whether the Coalition decides to implement regulations or not.</td>
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<tr>
<td>Set price ceiling to zero</td>
<td>A price ceiling is built into the CPM for the first three years of the flexible period to provide certainty to the market and to avoid extreme price fluctuations. Under this option, the Coalition could amend the price ceiling within the CPM to zero, which would, in effect, ensure that the value of every carbon unit could not be more than $0. However, this option would only impact on carbon units issued in connection with the flexible period, which may not present an immediate short term fix. And again, pursuing this option would require amendment of the CE Act.</td>
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Possible ways the Coalition could seek to alter or amend the CPM:

### Instructions to the Clean Energy Regulator (Regulator) to halt implementation and enforcement of the CPM

The Clean Energy Regulator Act 2011 (Regulator Act) establishes the functions and powers of the Regulator under the clean energy legislative package. If the Coalition instructed the Regulator to halt implementing and enforcing the CPM, it would need to consider the effect of such an instruction on the Regulator’s ongoing responsibilities under the Carbon Farming Initiative (CFI), the Renewable Energy Target (RET) and the National Greenhouse Gas and Energy Reporting System (NGERS). Under s41 of the Regulator Act, the Minister may, by legislative instrument, give directions to the Regulator in relation to the performance of its functions and the exercise of its powers. However, s41(2) and (3) limit the extent of this power. Firstly, the direction must be of a general nature only. It is unlikely that a direction to stop implementing the CPM would satisfy this requirement. Secondly, the direction must not be inconsistent with the objects of the clean energy legislative package; and it is an objective of the CE Act “to put a price on greenhouse gas emissions”. Any direction to the Regulator to halt implementation and enforcement of the CPM would therefore be contradictory to the objectives of the CE Act.

### Halting funding to the Regulator

This option draws on much of the analysis of the previous option. The clean energy legislative package contains various legal obligations that the Regulator must comply with. If the Coalition were to halt the funding to the Regulator, it would not be able, practically, to fulfil its function to operate the CPM. However, this option, which would be contained in a Budget, could be blocked by the Senate and could potentially lead to litigation against the Regulator. In this context it is worth noting that “any financial liabilities of the Regulator are taken to be liabilities of the Commonwealth” so a Coalition government could expose itself financially if it was to take this option. Additionally, the Coalition has stated that it will require the Regulator to administer its Direct Action Emissions Reduction Fund, as well as the RET, CFI and NGERS, therefore to halt its funding would impact on the Regulator’s ability to administer those policies.

### Not proceeding with the auction process

Under the CE Act, during the flexible charge years, a carbon unit may be issued as the result of an auction, as opposed to being issued by a fixed charge under the fixed charge years. The auction process, including the number of carbon units offered at auctions, is one of the essential instruments required to enable the CPM to operate as a fully functioning emissions trading market. The CE Act contains requirements for the Regulator to begin the auction process for units with the first vintage year of the flexible period, from 1 July 2013. It is expected that the Regulator will release its calendar for this auction process in the coming months. If the Minister were to direct the Regulator not to adhere to its obligations under the CE Act and not to proceed with the auction process, this direction would be counter to the objectives of the CE Act and any bill attempting to prevent the auction process would likely be blocked by the Senate (as set out above).

From the above discussion, it would appear that Labor, with the support of the Greens and the Independents, has done a good job of producing an “Abbott proof fence” and the CE Act has been well designed to protect the CPM against any significant amendment. There is no clean way for the Coalition to simply amend the CPM, through regulation or legislative instruments, so that it would no longer function as originally designed. Therefore, the Coalition will need to pass primary legislation to amend the CE Act, and will therefore face the same political and timing hurdles as for the full repeal option.

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13 Greg Hunt, appearing on ABC TV Q+A A Show About Nothing (18 February 2013). In response to a question on whether the Coalition would ever move to some form of emission scheme, Greg Hunt responded “I don’t see it’s ever likely to happen.”

14 This assumes either the Coalition having support in the Senate (either in its own right or with the cross-benchers) or Labor supporting this move.

15 S100 of the CE Act.

16 Under s16(3) of the CE Act, the Minister must take all reasonable steps to ensure that these regulations are tabled in the House of Representatives and the Senate not later than 31 May 2014.

17 S17 and s18 of the CE Act.

18 S12 and S13 of the Regulator Act.

19 S3 (d) of the CE Act.

20 S14 (1) of the Regulator Act.

21 S102(1) and (2) of the CE Act.
Implications for business and carbon markets of CPM repeal or amendment

Australia’s carbon pricing regime (including household compensation packages and assistance for business) is complex. The effects of repealing the CPM will be extensive and will have implications for liable entities, funding arrangements under assistance packages, carbon markets, carbon transactions, households and the wider business community.

**Impacts on liable entities**

A repeal or amendment of the CPM will most directly impact the approximately 350 liable entities under the CPM. Liable entities will have put in place various arrangements to manage their carbon liabilities. These could include:

- establishing compliance systems
- entering into or amending contracts to manage their carbon exposure
- investing in emissions abatement projects or offset projects under the CFI, and
- purchasing eligible emissions units for compliance purposes.

Liable entities will have invested substantial time, resources and money into developing strategies, systems and operations to fulfil their obligations under the CPM and will have developed a complicated contractual web between themselves, government, suppliers and customers. In particular, we are aware, from advising many liable entities, that significant resources have gone into identifying and understanding their liability and in most cases, contracting to pass on that liability to their customers or consumers where possible.

Although a repeal of the CPM is far from certain, liable entities should still be giving consideration to this being a possibility prior to the Election and identifying any potential exposures or opportunities. If a repeal does materialise, liable entities will need to understand how to acquit their existing liability through any transitional period and to manage any exposure or risks under existing contractual arrangements which have factored in a carbon price or which are predicated on the existence of the current CPM.

If there is a substantial amendment to the CPM, liable entities will still need to assess the implications in terms of ongoing compliance costs, and understand the nature of any ongoing obligations or opportunities. This will be particularly important where those arrangements have been put in place for the medium to long term and include the sale or surrender of carbon units of an assumed value to government or the private sector in exchange for funding, finance or other services.

**Impacts on business**

The impact of any repeal or significant amendment will also be felt by businesses who are not directly liable under the CPM, but which have been on the receiving end of carbon cost pass-through or have otherwise been indirectly impacted by the CPM.

The future of the different industry specific assistance schemes under the CPM will also be a key concern for business. The CPM has been designed to provide assistance to a number of different sectors in order to reduce both the direct and indirect impacts of the carbon price and to support industry transition and jobs in exposed sectors. The main assistance packages in place are:

- the Jobs and Competitiveness Program which provides free carbon units to activities in sectors such as the steel manufacturing, aluminium, cement, pulp and paper sectors
- additional measures to help directly improve energy efficiency in manufacturing industries and support research and development in low pollution technologies (Clean Technology Investment Program, Clean Technology Food and Foundries Investment Program, Clean Technology Innovation Program)
- the Steel Transformation Plan to provide transitional support to the steel industry
- support for the coal sector through the Coal Sector Jobs Package and the Coal Mining Abatement Technology Support Package.
### Impacts on business continued

Given that these programs are essentially designed to offset the cost and market impacts of the CPM, it is not clear what their future will be if the CPM is repealed. Any proposal to remove and reduce assistance from the Jobs and Competitiveness Program is likely to raise particular challenges. For example, the market is already seeing free carbon units being treated as cash and commoditised by banks and liable entities may already have budgeted for the free and tradeable units that they can expect to receive under the Program.

The Coalition has provided only minimal detail on its approach to ongoing assistance in the event of the CPM being repealed. For example, The Hon Greg Hunt, Shadow Minister for Climate Action, Environment and Heritage (Shadow Minister Greg Hunt), has indicated that the Coalition will not seek to claw back the $1 billion in cash payments that have already been made to power generators but that there will be no compensation to any businesses that believe they will be disadvantaged by a repeal.\(^2\)

### Impact on households

The CPM was accompanied by a number of changes to Australia’s tax system as a means of delivering compensation to households most likely to be impacted by a price on carbon. For instance, the tax-free threshold was raised, there were increases to pensions, and family tax benefits and tax exemptions for low income households were introduced.

While the Coalition has said that it will retain the increase in the tax-free threshold and increases in pensions, it is unclear if other household assistance measures will be maintained and, in any event, how they would be funded. If these benefits remained in place under a Coalition government, it would have to find alternative ways of funding these arrangements, as there will be no income generated from the sale of carbon units without the CPM in place. As an example, for the 2013/2014 financial year the household assistance package is estimated to cost $4.672 billion.

### Impact on Funding and Governance Arrangements

The clean energy legislative package included the establishment of a variety of funding arrangements to support the CPM and help deliver Australia’s clean energy future. For example, the Government established the Australian Renewable Energy Agency (ARENA) to administer $3.2bn in existing Commonwealth Government support for R&D, demonstration and commercialisation of renewable energy technologies. It is not clear at this stage what the impact of the Coalition policies would be on ARENA and any funding arrangements that it has entered into.

To date, the Coalition has been ambivalent about ARENA’s level of funding, stating that it would be reviewed in connection with other funding at the relevant time, but it has been critical of the current Government’s approach to grant-tendering for emerging technologies. The ARENA funding model – the commitment of significant tranches of money for new technology which is designed and expected, but not yet proven, to deliver energy efficient power – is in direct contrast to the Coalition’s preferred reverse auction process for proven and lowest cost measures.

As mentioned earlier, the Coalition has stated that it will disband the CEFC. If this occurs, there are likely to be transitional arrangements that would need to be managed given that the CEFC has indicated it has legal obligations to continue operating. This is likely to mean that the CEFC will have entered into contracts prior to any repeal of the CPM which may involve ongoing obligations to fund or to honour guarantee claims or to pay compensation.

Similarly, the Government is continuing to enter into funding arrangements across all of its assistance packages. Many of these provide for large amounts of funding over a number of years for the carrying out and completion of large-scale energy efficient and low pollution projects. Typically, the private sector uses the Government assistance to secure additional finance. Any repeal or significant amendment of the CPM will remove the budgetary source for much of this funding.

The Government of the day will only be able to terminate such arrangements in accordance with their agreed terms or by relying on the doctrine of executive necessity. On the basis of the NSW Supreme Court 2012 decision in *NSW Rifle Association v the Commonwealth*\(^23\), and the associated public backlash, reliance on the doctrine of executive necessity to exit such arrangements is unclear and will be inherently risky. In the circumstances of that case, His Honour Justice White held that a change in policy was insufficient to invoke the doctrine of executive necessity.

More likely, the Government of the day would need to rely on the ubiquitous termination for convenience clause which will carry with it compensation to the recipient of the funds. In our experience of these arrangements, it is not uncommon for the compensation obligations on Government to outweigh the financial benefit of termination.
The future of the Carbon Pricing Mechanism – Managing uncertainty

**Impact on Carbon Markets**

A Labor victory at the Election is likely to have a stabilising effect on the Australian carbon market on the basis that the future of the CPM and its existing architecture would remain in place. In this context, one would expect liable entities and other market participants to develop longer term strategies with respect to carbon related investments and the purchase of carbon units and other eligible emissions units on the domestic and international market.

However, if the Coalition wins government, there is likely to be a more protracted period of uncertainty for the Australian carbon market, unless the CPM is tweaked rather than repealed. This is on the basis of our conclusion above that a repeal of the CPM is unlikely to take effect until the final year of the fixed price period (2014-2015) and factoring in that the details of the Coalition’s alternative regime under Direct Action will take time to develop and implement.

In this environment of uncertainty, businesses may be hesitant to participate in the advance auctions of carbon units scheduled for the first half of 2014 or to enter into forward contracts for eligible emissions units (such as Australian Carbon Credit Units, which are generated through CFI projects). Any forward contracts entered into during this period are likely to include clauses which factor in the scenario of the units not being able to be used in an Australian compliance market if the CPM is repealed. The willingness of liable entities or other carbon market participants, such as banks, to participate in advance auctions will obviously be influenced by the Election result, but will also be informed by the early signals from a Coalition government about the process and time frame of a repeal of the CPM and its position with respect to compensation for units purchased prior to a repeal.

**Impact on links to International Carbon Markets**

The announcement by the Australian Government and European Commission in August 2012 to link the CPM and EU ETS was greeted positively by the international carbon market. If nothing else, it gave the market a psychological boost in the context of the subdued state of the European market under its EU ETS and the record low prices of Certified Emission Reduction (CERs) under the Clean Development Mechanism.

The first stage of the linking proposal was formalised in Australia with the passing of legislation in November 2012, paving the way for Australian liable entities to purchase European Union Allowances (EUAs) to acquit up to 50 per cent of their liability from 1 July 2015. Further negotiations between Australia and the EU have started and the aim is to formalise, by mid 2015, a two way linkage between the EU ETS and CPM which will commence on 1 July 2018. This would allow liable entities under the EU ETS to purchase Australian carbon units for compliance purposes.

Discussions between the Australian Government and other jurisdictions about potential opportunities for linking the CPM with other national and sub-national emissions trading schemes have also been taking place (e.g. California, New Zealand, South Korea and China).

These developments add an additional ingredient to implications of the Election result and a possible repeal of the CPM. The linkage with the EU ETS from 1 July 2015 means that the CPM’s carbon unit price will closely track the EUA price. Given current projections of future EUA prices (and even factoring in a potential small uplift in prices from the current “backloading” proposal) it is expected that the price of carbon units from 1 July 2015 will fall significantly from the fixed period price. This would have a significant flow through effect on the cost of compliance under the CPM and the revenue stream from the CPM to the Government.

A full repeal of the CPM by a Coalition government would end any short term prospect of a linkage between the European and Australian compliance markets. It is also likely to have a significant impact on the international perception of Australia in international carbon markets and at the United Nations Framework Convention on Climate Change (UNFCCC) negotiations. Although the Coalition has said it supports Australia participating in a second commitment period of the Kyoto Protocol, and a domestic target of 5 per cent emissions reductions by 2020, the international community will have a keen interest to understand how the Coalition’s Direct Action policy will contribute to these commitments and interact (if at all) with the international compliance and voluntary markets.

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22 No Compensation’ attached to carbon price repeal: Coalition, Carbon and Environment Daily (26 February 2013).
25 The “backloading” proposal has the effect of taking out 900 million EUAs from the first three years of Phase 3 of the EU ETS and reintroducing these in the last two years of the Phase. There are differing views on the likely impact on EUA prices of the backloading proposal. Some commentators have suggested that the proposal has already been factored into the EUA futures price.
The Direct Action alternative to the CPM

Following the Election, the Coalition intends to implement its Direct Action Plan (Direct Action) in place of the repealed CPM. Direct Action, drafted in 2010, currently forms the cornerstone of the Coalition’s climate change policy and although the Direct Action Plan itself does not contain much detail, Shadow Minister Greg Hunt has recently been adding more substantive detail to the policy.

Tagging the CPM as a tax on electricity, the Coalition’s policy operates as an incentive based instrument, rather than imposing a cost on the carbon “polluters”. The principal plank of Direct Action is the establishment of an Emissions Reduction Fund (ERF). Over the first three years of the ERF, the allocations to the fund will be $300 million, $500 million and $750 million respectively.

Through the ERF, the Coalition will invite businesses, through an auction process, to tender for projects that will reduce carbon dioxide emissions. The ERF will use the existing NGERS to determine proposed emissions reductions beyond overall base levels already determined by individual firms. It will also be possible for business, not already covered by NGERS, to “opt-in” to benefit from the fund.

Of note, the Coalition’s policy states that businesses continuing to operate at “business as usual” levels will not be penalised. However, businesses whose emission levels are higher than their “business as usual” levels will incur a financial penalty, which will be calculated on a sliding scale “at levels commensurate with the size of the business and the extent to which they exceed their “business as usual” levels”. The Coalition has, so far, not provided any additional detail about the level, or operation, of these penalties.

It is also notable that Direct Action relies heavily on soil carbon as a means to achieve a 5 per cent reduction of Australia’s greenhouse gases by 2020. Through the ERF, the Coalition proposes to support up to 85 million tonnes of CO2 abatement per annum from soil carbon activities by 2020 at an indicative cost of A$8-A$10 per tonne.

More recently, Shadow Minister Greg Hunt has advised that the ERF will be distributed through the existing CFI framework. This will enable abatement action to be accredited through a similar process to the existing CFI methodologies, however the intention is that more activities than are currently covered by the CFI will be able to participate. Such an example would be energy efficiency activities. The Coalition would seek to purchase the lowest cost form of abatement through “abatement auctions”. In essence, Direct Action would operate as a “carbon buy back” scheme, on a similar basis to the water buy-back model currently being implemented by the Federal Government.

It is currently unclear how much more detail will be provided by the Coalition on their Direct Action policy prior to the Election. The Coalition has stated that it will undertake a White Paper policy development process if it is successful at the Election. Experience would indicate that the steps associated with the development, consultation and subsequent legislative process will take some time, possibly at least six months.

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29 Oral comments made by Greg Hunt at the National Environmental Law Association Conference on 8 March 2013.
What Direct Action may look like when implemented

<table>
<thead>
<tr>
<th>What will stay/be created</th>
<th>What will go</th>
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<tbody>
<tr>
<td>CFI. Greg Hunt has stated the Coalition will expand the number of methodologies, including using Clean Development Mechanism methodologies. Creation of the ERF to support 140m tonnes of abatement per annum by 2020.</td>
<td>CPM</td>
</tr>
<tr>
<td>The Regulator. It will be tasked with administering the ERF.</td>
<td>The Departments of Climate Change and Environment will be merged and the Climate Change Authority, Climate Change Commission, Clean Energy Finance Corporation and Energy Security Council will be abolished. At the time of going to press, the Government had just announced the merger of the majority of the functions of the Department of Climate Change and Energy Efficiency with the Department of Innovation, Industry, Science, Research and Tertiary Education with remainder of the functions merging with the Department of Resources, Energy and Tourism.</td>
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<td>NGRS</td>
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<td>Renewable Energy Target.</td>
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<td>Although the currently scheduled review in 2014 may allow the Coalition to tinker with the existing scheme.</td>
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Developing a strategy for managing uncertainty

The dynamics of the upcoming Election and the uncertainty over the future of the CPM leaves business with difficult decisions to make in the short term. In our view, it would be unwise for this uncertainty to result in a “head in the sand” approach and we consider it important for businesses, particularly those who are directly impacted by the CPM, to have a strategic plan in place to manage the uncertainty and to ensure they are prepared for any result. Below we outline some important factors that businesses should consider, both in the lead up to the Election, and subsequently.

Compliance obligations

First and foremost, businesses must ensure that they put in place arrangements to comply with the CE Act and associated legislation, such as the National Greenhouse and Energy Reporting Act 2007 (NGER Act) and the Australian National Registry of Emissions Units Act 2011 (ANREU Act). For example, liable entities under the CPM will still need to purchase and surrender Australian carbon units equivalent to 75 per cent of their liability for 2012-2013 by 15 June 2013 and the remaining 25 per cent by 1 February 2014. Depending upon the timing of a Repeal Bill being passed and any transitional arrangements that need to be put in place, it is possible that liable entities will have to go through the same process for the 2013-2014 year.

There is no indication that the Coalition would seek to repeal or tinker with the NGER Act (indeed, the reporting completed under this Act is required to support Australia’s international obligations under the Kyoto Protocol). Consequently, companies will still need to keep in place their NGERS reporting function and work towards submission of their NGERS reports for the current compliance year by 31 October 2013.

Contractual reviews

Many counterparties (both liable entities and others) undertook contract reviews at the time that the CPM was introduced. The main objective of this exercise was for liable entities to seek to pass on their costs incurred through the introduction of a price on carbon and, for those who were price takers, to review their obligation to accept the carbon price. Whether a full pass through of carbon related costs was possible often depended upon the extent of the relevant “change in law” clause.

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31 Joe Kelly, In this climate, one department’s not safe, The Australian (02 March 2013).
New contracts or contract amendments also factored in the costs associated with carbon pricing, and we helped a number of clients develop sophisticated drafting to deal with both carbon cost pass-through and receipt of carbon costs. Now is the time to assess whether carbon cost pass-through clauses developed at the time of introduction of the CPM factored in a repeal scenario, and if not whether additional amendments to existing contractual arrangements are required. This will be particularly important for those entities on the receiving end of the carbon related costs.

Energy efficiency
The most obvious steps for liable entities and other energy intensive businesses to consider, regardless of the outcome of the Election, are opportunities to improve energy efficiency. Even with a repeal of the CPM energy costs are likely to increase and there will be more pressure on business to find ways of reducing their energy bills. Many energy efficiency measures have short pay back periods and can be easy to implement with the right internal support and access to information.

The only potential downside to taking energy efficiency steps now is the possibility of having such action counted under the Coalition’s Direct Action plan. Moving too early may mean that the action would be seen as “business as usual” and would therefore not satisfy any possible additionality requirement incorporated into funding arrangements under the ERF.

Fuel switching
It is likely that the RET will remain under a Coalition government, although there is uncertainty as to whether the Coalition would use the currently scheduled review in 2014 to make any changes to it and there are rumblings of the Coalition looking to reduce the current 2020 target of 41,000 gigawatt hours. Assuming that it remains in place, however, a key option of abatement for businesses in the short term is to switch to lower-carbon sources of electricity, such as switching from coal to natural gas. However, businesses still need to balance the extent of fuel-switching with electricity demand, fuel prices and technology costs.

Investment opportunities
If investors expect the CPM to be repealed, then even the currently high fixed carbon price is unlikely to promote investment in carbon-reducing projects in the short term. This is particularly the case as most significant projects require longer investment timeline certainty than three years. If the uncertainty over the carbon price in Australia continues, then investors may take up other opportunities, thereby limiting the availability of financing in Australia, raising the price of the available financing and limiting the quality and capability of investors. It is important for businesses who enter into commercial clean energy project contracts to build in mechanisms for dealing with the current instability. Businesses should consider contract variation clauses, dispute resolution clauses, funding change clauses and settlement or completion date waivers.

Review of Funding Arrangements
The tension remains between the independent CEFC and the Coalition as to the lawfulness of the CEFC’s activities prior to the Election. If the CEFC does enter into contracts, and commences funding from 1 July 2013, recipients of those funds should take care to understand the extent to which those arrangements are enforceable and, if not, the consequences of unenforceability. This is particularly the case where the CEFC funding has been relied on to obtain additional private sector finance and where subsequent project contracts have been let on the basis of both.

Similarly, recipients of other Commonwealth government funding under the broader clean energy future package should review termination provisions and, if applicable, compensation mechanisms, and identify where any risk may lie within those agreements and their consequential project contracts.

Opportunities under the Carbon Farming Initiative
Significant momentum has been building over the last 12 months under the CFI, with a steady increase in the number of methodologies and projects being developed and approved across a number of farming and other land based sectors. Although the supply of Australian Carbon Credit Units (ACCUs) under the CFI is still relatively small (approximately 400,000 ACCUs had been issued at the time of writing), the demand from Australian compliance buyers under the CPM appears to be healthy, as reflected by a fairly stable market price in March 2013 of about $22.50.

Although there is evidence that CFI activity is continuing to grow in the lead up to the Election, the uncertainty about the CFI’s form and place in the post-Election climate change policy framework creates a number of challenges for businesses trying to include the CFI in their carbon response or investment strategies. In particular, given that the CPM currently provides the domestic compliance market for ACCUs, a repeal or equivalent of the CPM by a Coalition government is likely to impact on the demand and therefore...
the price of ACCUs in the Australian market. It is possible that a Coalition would become the sole buyer of ACCUs under its ERF, but the volume and prices associated with any such purchases are hard to predict without further details being known.

In this environment, it is very difficult for businesses wanting to invest in CFI projects or purchase ACCUs to predict what the future price curve looks like. While there have been a number of recent examples of liable entities and intermediaries proceeding with CFI transactions, anecdotal evidence suggests that most transactions have focussed on purchase commitments in the fixed price period with provision for call options for future purchases. Investment and purchasing activity is likely to be stifled in coming months until the future policy settings are resolved.

In the interim, for any business considering entering into an agreement to purchase ACCUs, care should be taken to ensure that the agreement contains appropriate pre-conditions, provisions dealing with delivery and acceptance failure and change in law provisions.

Taking a long term view

There may be some liable entities who conclude that it is more unlikely than not that the CPM will be repealed. For example, the analysis undertaken by Bloomberg would justify taking such a position. 32 If such a view was taken, there would be an advantage now in purchasing EUAs and/or CERs, given the record low prices at which both are currently trading. Even in the event that repeal actually took place, these units would still have a value and would be able to be sold back into relevant compliance markets, such as the EU ETS. Alternatively, rather than purchasing these units now, liable entities could enter into forward contracts or options, such that they could be in a position to take delivery of these units in 2015, when they can be used for compliance purposes.

A longer term view may also have regard to the likely outcome of the Climate Change Authority’s (CCA) report on targets and pollution caps, which is due out in October. It is very possible that when the CCA reviews both the latest science and the action that is being taken elsewhere in the world to address emissions reduction, it may determine that a higher target than the current 5 per cent reduction by 2020 is warranted. In these circumstances, it is feasible that the Coalition may see no other policy response other than retention of a market based mechanism, such as the CPM. The alternative would be for the Coalition to find additional funding to support its ERF to achieve greater levels of abatement.

Understanding other policy and regulatory settings and drivers

It will be important for business to maintain a watching brief on developments, both domestically and internationally, in climate change policy development and formation.

One scenario in the domestic context is that with repeal of the CPM, Australian States and Territories may feel it necessary to review their own policy and regulatory settings for mitigation. For example, the Climate Change and Environment Protection Amendment Act 2012 passed at the end of last year repealed the 20 per cent reduction target set out in the Victorian Climate Change Act 2010 and a recent Statement of Regulatory Intent stated “The introduction of the national carbon price mechanism means that there will be a limited requirement for the Victorian Government to consider new policies or regulations relating to the management of any greenhouse gas emissions for the purpose of mitigating climate change ....In particular, it is expected that EPA regulation will not be applied as the principal mechanism for greenhouse gas abatement directed to climate change mitigation; this being instead managed by the national carbon price.” 33 Such positions may need to be revisited in the absence of the CPM and we may see a return to the proliferation of state based approaches, such as has occurred in the energy efficiency context.

In international terms, the lead up to the UNFCCC talks, which will take place in Paris in 2015 and at which it is expected that an overarching legally binding agreement of some form will be reached, will be of importance. Even regardless of this outcome, it will be important for Australian business to monitor what is taking place in other parts of the world in terms of the regulatory framework for addressing climate change. There are now emissions trading schemes operating, or in development, in the European Union, New Zealand, California, Alberta, Quebec, Kazakhstan and South Korea and 7 pilot schemes are in the process of being implemented in China with the long term goal to move to a national scheme. We are working with the Business Partnership for Market Readiness developed by

34 Bloomberg New Energy Finance concluded that there was only a 32 per cent chance that the CPM would be repealed after the Election.
the International Emissions Trading Association, off the back of the World Bank’s Partnership for Market Readiness, and funding has recently been allocated by the World Bank to Mexico, Chile and Costa Rica to investigate the introduction of emissions trading schemes in these countries. The possibility of an emissions trading scheme has also resurfaced on the USA agenda following recent comments made by President Obama and others (please see our legal update - *Climate Change Back on the Front Burner: Beijing & Washington DC - A Tale of Two Cities* on nortonrose.com).

It is becoming increasingly clear that some countries are viewing moving towards a carbon constrained economy as a realistic prospect, and are taking steps to position themselves to ensure energy security and to capitalise on the new technology and cleaner forms of energy required to support such a world. Australia and the Australian investment and business community has its own opportunities to maximise the benefits which will emerge in a low carbon future.

**The science**

At the end of the day, the primary reason underlying the need for action on reduction of greenhouse gases rests on the science. Over the next 12-18 months we will see the publication of the 5th report of the Intergovernmental Panel on Climate Change. All early indications are that the report may be suggesting that a 2°C warming target may now be unobtainable. A recent report by the World Bank states:

“*Despite the global community’s best intentions to keep global warming below a 2°C increase above pre-industrial climate, higher levels of warming are increasingly likely. Scientists agree that countries’ current United Nations Framework Convention on Climate Change emission pledges and commitments would most likely result in 3.5 to 4°C warming. And the longer those pledges remain unmet, the more likely a 4°C becomes*.”

The implications of this are significant. PWC recently suggested that to “give ourselves a more than 50 per cent chance of avoiding two degrees will require a six-fold improvement in our rate of decarbonisation.”

Associated with the increasing incidence of climate related events (e.g USA’s Superstorm Sandy, Thailand’s floods, Brazil’s drought and Australia’s own increasing levels of fires and floods), the global community may decide it has no option but to move faster and deeper to achieve the necessary emissions reductions. Evidence points to a market based mechanism, such as an emissions trading scheme, being the most cost effective way to achieve such an outcome.

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35 Turn Down the Heat, What a 4°C Warmer World Must be Avoided, World Bank, November 2012.
How Norton Rose can assist

If you would like any further detail or advice on how the issues, obligations and opportunities presented within this analysis may affect your business and the decisions that you make during 2013, please contact a member of our Climate Change team. Through its involvement on various working groups and committees, our Climate Change team is likely to be involved in ongoing discussions with both Labor and the Coalition over the coming months, and if you would like to feed into any of these discussions, we would welcome your input.

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