Garnaut builds the case for urgent action on climate change

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PricewaterhouseCoopers

At a glance

- Professor Ross Garnaut has released a 537-page Climate Change Review Draft Report (June 2008) (the Report), building a case for urgent action on climate change and indicating possible responses.
- Major new proposals affecting business:
  - The National Emissions Trading Scheme should be as broad as possible and include transport and petroleum from the outset, but initially exclude the waste and forestry sectors and consider inclusion of the agriculture as data becomes more robust
  - The Government could consider a fixed-price transitional scheme during 2010–12, although this is not optimal
  - Permit revenue should be used to compensate households, affected businesses and support R&D in a 50/30/20 ratio
  - Compensation for the owners and operators of coal-fired plants should be given a low priority, as offsets, trade in permits, hoarding and lending of permits would allow sufficient financial flexibility. Firms which are Trade-exposed emission intensive, however, might be worthy of consideration for compensation
  - There is a need to reform Australia's electricity and CO_2 distribution networks
- Still to come: detailed modelling for targets, trajectories and economic impact.
- Tight deadlines: business will have little time to lodge submissions between the release of the Government's Green and White Papers (see Key dates).

About the Garnaut Climate Change review

The Climate Change Review Draft Report is the eighth in a series released by the internationally respected economist Professor Ross Garnaut as head of The Garnaut Climate Change Review, an independent study group established on 30 April 2007. Australia's Commonwealth, state and territory governments have commissioned the Review to examine the impacts of climate change on the Australian economy, and recommend medium to long-term policies and policy frameworks to improve the prospects for sustainable prosperity.

See www.garnautreview.org.au for the Review's terms of reference, reports and other information.

Key dates

4 Jul 2008	Garnaut Climate Change Review Draft Report released
16 Jul 2008	Government Green Paper on design of the National Emissions Trading Scheme
Late Aug 2008	Supplementary Draft Report with data modelling
30 Aug 2008	Release of the Treasury Modelling, highlighting economic implications of emissions reduction scenarios
30 Sept 2008	Garnaut Review Final Report due to be released
Sept 2008	Release of Government White Paper
Dec 2008	Release of proposed climate change legislation
Mar 2009	Legislation to be voted on in Parliament
2010	Proposed introduction of ETS

Introduction

The Garnaut Climate Change Review Draft Report released on Friday (4 July) does not provide all the answers for businesses to assess how the proposed National Emissions Trading Scheme (ETS) and other climate change responses will affect their operations and earnings. However, at 537 pages it is a substantial contribution which we believe will come to eclipse even the influential 700-page Ralph Report on business tax reform released in 1999.

At its core, the Report is designed to persuade business, politicians and the community there is an urgent case for action on the "insidious, long-term"[1] challenges presented by climate change. According to Professor Garnaut, Australia has made enormous gains over the past 70 years and is in a position of strength to address climate change. He also commented that taking no action is in itself a decision. This paper is an important precursor to the Government's Green Paper on the design of the ETS due to be released by Senator the Hon. Penny Wong, Minister for Climate Change and Water, on 16 July.

1 Professor Ross Garnaut, National Press Club Address, 4 July 2008

How will climate change impact the economy and what is Australia's emissions target?

The Report contains extensive projections of the potentially disastrous impact of climate change on Australia if no action is taken. This includes a 4.8% reduction in GDP by 2100 and the collapse of the Murray-Darling system. Garnaut argued that Australia is particularly susceptible to climate change and must help drive a global response. He also focused on the interdependent relationship between the developed and developing world and highlighted that, based on current trends, China would contribute 35% of global emissions in 2030.

However, the Report does not contain the quantitative economic modelling that was originally expected. This will be done with Treasury and provide data on emissions targets and trajectories (which will determine emissions limits and, in turn, the carbon price) as well as the impact on the Australian economy. These are expected to be provided in late August in a Supplementary Draft Report. The Professor's Final Report is due by 30 September 2008.

Australia's current goal is to cut greenhouse gas emissions by 60% by 2050 and, until 2012, our emission targets are the same as the Kyoto targets. The Report does add the proposal that trajectories should be firm for five-year periods and indicative through to mid-century, but gives no guidance on likely emissions reduction targets in the short-to-medium term or a carbon price.

The Report also restates Professor Garnaut's view that a Mandatory Renewable Energy Target (MRET) will not address any additional market failures and can be phased out naturally once the ETS is fully operational. However, he proposes keeping the existing shortfall penalty.

Nuclear power is not proposed as a part of Australia's current climate change response. The Report recommends continuing to export our uranium, while pursuing low-emission coal, gas and renewable energy options.

How will the ETS work?

The Report confirms or introduces key principles for the operation of the ETS, many of which can be expected to feature in the Government's forthcoming Green Paper. These include:

The ETS should be as broad as possible

Professor Garnaut confirmed his preference that the Government introduce a market-based response to climate change and said the ETS should be as broad as possible. According to the Report, the scheme should cover stationary energy, industrial processes, fugitive emissions from fuel production and transport from the outset. This would maximise efficiency and effectiveness, and has the capacity to change society's behaviour.

Professor Garnaut's criteria for including a sector in the ETS are that its emissions should be able to be measured and verified at a cost which is not prohibitive. He advocates the inclusion of the forestry and waste sectors as soon as practicable. The inclusion of agriculture will be subject to progress on measurement and administration. The relevant gases will be the six defined by Kyoto.

Interestingly, he sees possibilities for Large Energy Users to opt into the scheme and accept an obligation for their (indirect) stationary energy emissions. For the same reason he identifies Large Liquid Fuel Users, such as fleets or freight operators, might also be allowed to participate.

Significantly, the Report argues that in coming years 'natural' rises in energy costs will be far greater than any incremental cost of climate change mitigation measures.

Possible two-year introduction period

For the first time, Professor Garnaut raises the possibility of a two-year staged introduction for the ETS. This would see carbon prices fixed to reduce the impact of the scheme. However, he describes this soft start as a "legitimate second-best" alternative to an unconstrained system from day-one. During the period to 2012, Garnaut accepts international permits and credits would be added into the Australian scheme but would not occur unless the price of certified emissions reductions and international permits was less than the fixed price permit in the Australian scheme.

Permits should be auctioned

The Report proposes emission permits are to be auctioned. This is one of a number of pragmatic conclusions in the Report. In this case, Professor Garnaut argues that allocating permits would simply be too complicated and time consuming. The Report confirms companies should receive credits if they emit less than their allowable limits and be able to sell those credits to other emitters. The Report also indicates that offsets could be created by organisations other than scheme participants. It makes the point however that 'additionality' principles would need to be satisfied, for example 'regulatory additionality', requiring emissions mitigation to be undertaken beyond what is undertaken to comply with existing legal or regulatory requirements. The Report also says permits should begin to be sold into the market as soon as possible after the full details of the scheme are finalised to provide a guide to price.

Companies could forward purchase permits for up to five years

The Report proposes the unlimited hoarding (net banking) of permits and for the official lending of permits by the proposed independent carbon bank, within five-year periods. The exception would be fixed-price permits for any 2010–12 transition period.

The Report also refers to concerns about the timing of auctions and cash-flow problems associated with the purchase or permits. Professor Garnaut believes that an

elaborate financial services system will develop to address this potential issue, although he does propose that the independent regulator consider establishing a deferred payment plan.

The Report again raises the need for financial accounting standards and tax rules to be finalised in advance of the ETS commencing. Whilst it does indicate that permits granted free to trade-exposed industries will be treated as "income", there is uncertainty around whether this will be for the purposes of accounting, tax or both.

Improve network infrastructure and allow feed-in tariffs

Australia will need to complete structural reform of its electricity and carbon-dioxide (CO_2) distribution networks to prevent market failures following the introduction of the ETS. The Report introduces the idea that the Building Australia Fund be extended to cover energy infrastructure. It also proposes paying citizens and others who contribute power to the electricity grid via feed-in tariffs.

Seek international integration

There would be a value in integrating Australia's ETS with those of other countries, with Japan and New Zealand as attractive early partners. Professor Garnaut also urges government and business to pursue early bilateral, group and sectoral arrangements rather than waiting for a complete, global regime. He notes there would be value in linking with the European Union trading scheme, but says differing views on agriculture and forestry presently pose barriers.

Key tax issues associated with the introduction of the ETS

The introduction of the ETS will be the most fundamental change to our economy since the introduction of the GST, and will have significant tax implications. Some of the critical tax issues identified as a result of the Report are as follows:

- GST – there is current uncertainty regarding the GST treatment of permits and, specifically, whether they will be treated as taxable supplies, input taxed or GST free
- R&D – the Report proposed that funding for R&D expenditure would be focussed on direct funding rather than tax concessions, and subject to a changing set of criteria which may disadvantage some businesses
- The importance of ensuring tax neutrality in transactions under the ETS, for example, avoiding distortion between the purchase of permits and other options for meeting emissions targets
- There will be substantial international tax issues arising from linking with international emissions schemes, such as - transfer pricing (pricing permits traded within global entities), deductibility of foreign permits, and structuring for global emission reduction projects.

How will permit revenue be used?

A major new detail in the Report is the proposal that all revenue from permit auctions should be returned to households, businesses or fund technology development after the costs of running the system.

The Report proposes that 50% of revenue goes to households in the form of tax breaks, social security payments or incentives to invest in energy efficiency. Up to 30% would be returned as compensation payments to trade-exposed, emissions-intensive industries (TEEI) and 20% would be used to fund research, development and commercialisation of low-emissions technologies.

The Report also suggests Australia should contribute about $3 billion a year to globally coordinated research aimed at finding technological solutions to climate change. Professor Garnaut said Australia might focus on geothermal, solar and CO2 sequestration technologies.

What compensation is available?

During his comments at the launch of the Report, Professor Garnaut made it clear that he was not persuaded by the arguments to compensate domestic power generators for future asset loss. He was however sympathetic to the financial plight that could befall TEEI enterprises – the financial effect of a carbon impost on trade exposed and emissions intensive enterprises could be such that an offshore relocation of Australia's production capacity could occur. Such an eventuality would not necessarily be reversible.

Ideally, Professor Garnaut stated that the protection of production capacity should be tackled firstly through a comprehensive global agreement on climate change mitigation that resulted in equal market conditions with respect to carbon imposts, or at least through the utilisation of international sectoral agreements for the trade exposed. In the absence of these, Garnaut proposed the establishment of strict "materiality thresholds" for determining which companies would qualify for compensation – compensation based on financial costs identifies as being above that deemed to representative of a reasonable shock relative to other vagaries of internationally oriented business.

Conclusion

The Garnaut Climate Change Review Draft Report raises serious issues for any boards and senior management teams that have assumed a business-as-usual approach to climate change mitigation. It reinforces the view that the Government is likely to take substantial action in the short-term and provides further detail on what this might comprise. With compensation looking less and less likely, the Report makes it critical for companies to engage in comprehensive business scenario planning as Australia begins the transformation of its energy supply.

www.pwc.com/au/climatechange

How PwC can help

The PricewaterhouseCoopers Sustainability & Climate Change Services team brings together experience across tax, audit, accounting, economics, engineering and legal to assist businesses to operate and succeed in an area which crosses so many disciplines.

We can help organisations through:

Carbon risk and strategy

We work with our clients in a collaborative manner to assess the risk and impact of the ETS on their strategy, value creating activities and outcomes and to identify the way forward. This advice ranges from a high level assessment of the current state of climate change readiness to more detailed reviews of specific business risks, for example, energy price risk. We also advise clients on their corporate and investment strategies, investor relations and wider stakeholder engagement.

Carbon finance and transactions

We work with both buyers and sellers of carbon credits in all the main carbon markets, offering a full range of transaction services. We also help our clients to assess the climate change risks and opportunities in corporate mergers and acquisitions and asset transactions and to understand the value implications.

Tax and legal

We provide advice to clients surrounding the tax, legal and accounting treatment of carbon emission permits, carbon offsetting contracts and other environmental products as well as review existing contracts to incorporate aspects of the ETS. We assist with the preparation of submissions in response to issues raised in the Report, Green Paper and/or White Paper. We also help clients prepare applications for R&D concessions and for funding with respect to investments in low-emissions technology.

Our Sustainability & Climate Change Services team has international and local experience in advising clients on risk and opportunity arising from regulation relating to climate change and carbon market rules.

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