Ashurst Australia
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Greenhouse Update

Emissions Reduction Fund: Safeguard Mechanism Consultation Paper released

WHAT YOU NEED TO KNOW

- The Government has released the consultation draft of the Emissions Reduction Fund Safeguard Mechanism.
- The consultation draft of the Emissions Reduction Fund Safeguard Mechanism identifies:
  - how (and to whom) the Safeguard Mechanism will apply;
  - the process for calculating emissions baselines for facilities;
  - special considerations for calculating emissions baselines for facilities in the electricity industry; and
  - mitigation measures to reduce an exceedance of an emissions baseline and enforcement options for the Clean Energy Regulator.

WHAT YOU NEED TO DO

- This is a key opportunity to provide input on the design of the Safeguard Mechanism. You should consider the proposed elements of the Safeguard Mechanism and how it may apply to your business.
- If your business is likely to be affected by the Safeguard Mechanism you should consider making a submission. Submissions are due by midday AEST on **Monday 27 April 2015**.

Introduction

In addition to incentivising participants to reduce emissions, the Emissions Reduction Fund (**ERF**) will employ a safeguard mechanism to encourage businesses not to exceed historical emissions baselines (**Safeguard Mechanism**).

The intent of the Safeguard Mechanism is to ensure that emissions reductions paid for through the ERF are not offset by significant increases in emissions elsewhere in the economy.

For more information on the latest updates to the ERF generally, and the first ERF auction, please see our earlier update of 24 March 2015.

Background

The Safeguard Mechanism is to be implemented by the amendments made to the *National Greenhouse and Energy Reporting Act 2008* (Cth) (**NGERS Act**) in November 2014.

The amendments to the NGERS Act set a high-level framework for the operation of the Safeguard Mechanism however the specific policy details, including:

- how baseline emissions levels are to be calculated;
- coverage thresholds; and
- penalties for exceeding baselines,

will be finalised in legislative rules (the **Safeguard Rules**).

The Government has now released the Emissions Reduction Fund: Safeguard Mechanism consultation paper, dated March 2015, (**Consultation Paper**) in order to seek business and community input on the operation of the Safeguard Mechanism and to assist in preparation of the Safeguard Rules.

The Government is scheduled to release a draft of the Safeguard Rules on or before July 2015, with the final Safeguard Rules to be made before 1 October 2015.

The Safeguard Mechanism is scheduled to commence on 1 July 2016 (**Safeguard Commencement Day**).

Application of the Safeguard Mechanism

Coverage

The Safeguard Mechanism will apply to facilities with direct emissions in excess of 100,000 tonnes of CO_2-e per year (referred to as a designated large facility under the amendments to the NGERS Act). According to the Consultation Paper, the Safeguard Mechanism is expected to capture around 140 businesses, with approximately 57 percent of covered emissions expected to come from the electricity sector.

How does the Safeguard Mechanism work?

The Safeguard Mechanism requires a "responsible emitter" of a designated large facility to prevent the net emissions from their facility from exceeding the baseline emissions levels during a monitoring period (a financial year).

"Responsible emitter" is a new term and means the person who has operational control of the facility on or after the Safeguard Commencement Day (**Responsible Emitter**).

The "operational control test" is a pre-existing test under the NGERS Act and persons who currently have National Greenhouse and Energy Reporting Scheme (**NGERS**) reporting obligations are likely to be the Responsible Emitters for the purposes of the Safeguard Mechanism.

Baselines

Ensuring emissions baselines are effectively determined was one of the key issues raised by industry participants in response to the ERF Green Paper. The Government has now established two separate processes for determining emissions baselines:

- Emissions baselines for existing projects will be calculated using the highest level of reported total direct emissions under NGERS over the historical period 2009-10 to 2013-14.
- For new facilities or significant expansions (ie facilities which increase production capacity by more than 20 percent through the installation of new plant or equipment) the Government is proposing to use a "best practice" emissions-intensity metric to determine baselines (defined as the average emissions intensity of production at the top 10 percent of the relevant Australian industry).

Under the Consultation Paper, the Government is proposing to allow facilities to adjust baselines where circumstances have changed where that historical NGERS data no longer reflects the current baseline emissions (for example, where facility boundaries have changed or entities have adjusted the basis upon which emissions are estimated).

As baselines will be applied to each facility individually, from 2014-15 each facility will be required to report its emissions separately. Entities which previously reported their emissions data under NGERS as an aggregate across a number of facilities will be given the opportunity to re-report emissions for each individual facility. If entities choose not to re-report, then the baseline of each facility will be calculated by the Clean Energy Regulator on a pro-rata basis using disaggregated data reported in 2014-15.

Baselines for the electricity sector will be calculated differently under the Safeguard Mechanism. Please see our comments below.

Electricity Sector

In submissions on the ERF White Paper and ERF Green Paper, electricity industry participants raised concerns that the Safeguard Mechanism would not adequately respond to volatility in the electricity sector. Electricity generators act as a single entity that coordinate production to meet a given level of demand at any point in time. To this end, establishing baselines for individual electricity generators, based on historical emissions levels, may result in low emissions generators (for example hydroelectric generators) choosing not to supply electricity in order to stay below the baseline, resulting in electricity load requirements being met by higher emissions-intensive generators.

To address these concerns, the Government has proposed applying a sectorial baseline to the electricity generation sector. A sectorial baseline will be set with reference to the average industry wide electricity generator emissions over a historical period. Setting a sectorial baseline based on average industry emissions is expected to average out any variability across the sector.

In the event that there is an exceedance of the sectorial baseline, individual baselines will apply to emissions-intensive generators in order to assign responsibility for reducing the sector's emissions.

Individual baselines will be set using the same historical NGERS data used to set the sectorial baseline (ie average generator emissions).

The Consultation Paper also suggests that if there is an exceedance of the sectorial baseline, then individual baselines will apply from the following financial year and apply thereafter. The sectorial baseline would not be re-established.

The Government has suggested that the sectorial baseline (and subsequently individual baselines) would only apply to grid connected generators with direct emissions of more than 100,000 tonnes of Co_2-e per year.

To calculate baselines for new investments and significant expansion in the electricity sector, the Government proposes to use the same "best practice" approach applied to new facilities and significant expansions generally.

Key insights

The Consultation Paper does not provide specific details about how individual baselines will be applied or how emissions-intensive generators will be identified. It is not clear whether all generators, regardless of fuel source, will be treated equally or if there will be concessions for legacy or base load generators which are likely to produce higher emissions due to their commitments in the National Electricity Market.

Although setting a sectorial baseline calculated on average emissions might reduce volatility across a sector, for individual generators a reduction in volatility is more likely to result from a baseline calculated using the highest level of reported total direct emissions. Generators may wish to apply to the Clean Energy Regulator to have their baselines adjusted. However, the Consultation Paper does not specify whether the mechanisms for adjusting baselines, available to other facilities under the general baseline setting mechanisms, will be available to electricity generators.

How will generators "pass through" the costs associated with exceedance of baselines to the market? Under the proposed structure, whether a liability will arise and the size of that liability will only be known at the time all reporting requirements under NGERS have been completed. This does not operate well in the National Electricity Market where the wholesale market is based on trading of OTC hedges and futures contracts and not linked to specific generation.

Mitigation and enforcement options

Mitigating baseline exceedances

Under the Consultation Paper, the Government has put forward potential options for businesses to manage emissions and mitigate any exceedance of an emissions baseline. These include:

- **Multi-year monitoring period**: facilities which exceed their baseline in one year may apply to the Clean Energy Regulator to gain access to multi-year monitoring periods of up to three years. Provided the emissions from the facility remain below the baseline over the monitoring period, the facility will be considered to have complied with the baseline requirements. The Government is also considering an option whereby a Responsible Emitter could apply for a multi-year monitoring period where there is a reasonable expectation that a facility's emissions will exceed its baseline.
- **Access to offsets and the ERF**: Responsible Emitters may voluntarily surrender "prescribed carbon units" to the Clean Energy Regulator, or sell the units to the Government under a Carbon Abatement Contract to reduce net emissions and remain below baseline levels.

  The amendments to the NGERS Act provide that a prescribed carbon unit may be either an Australian Carbon Credit Unit (**ACCU**) or other unit (issued inside or outside Australia) specified under the Safeguard Rules. Although the Government has not indicated that it intends to specify any other units outside of ACCUs as prescribed carbon units for the purposes of the Safeguard Mechanism, the amendments to the NGERS Act contemplate that Australia's carbon market might be opened up to allow foreign issued units to be purchased by facilities in order to reduce net emissions.
- **Exceptional circumstances**: the Safeguard Rules will include a mechanism that will allow the Clean Energy Regulator to disregard emissions increases linked to an exceptional event, such as a natural disaster or criminal activity.

Key insights

The ability to surrender ACCUs (and, potentially foreign issued units) to reduce net emissions will open up the market for ACCUs amongst emissions-intensive industries.

A secondary market is likely to increase competition for carbon units and businesses will need to compare the benefits of either:

- trading carbon units through the ERF auctions;
- selling carbon units on the secondary market; or
- (if necessary) using carbon to reduce their net emissions and any baseline exceedance.

Enforcement

The Consultation Paper proposes that a number of enforcement options will be available to the Clean Energy Regulator in instances where there is an emissions exceedance, including:

- issuing infringement notices;
- accepting enforceable undertakings;
- seeking injunctions to rectify an emissions exceedance; and
- applying for civil penalties to be imposed by a court.

The maximum civil penalty for an emissions exceedance will be specified by regulation. The regulations are not due to be released until later this year.

Once the maximum civil penalties have been specified by the regulations, businesses will have a better understanding of the actual cost of any baseline exceedance, or the value of any ACCUs on the secondary market.

Key insights

We consider the exposure to potential enforcement action, in particular civil penalties, to be a key risk for businesses. Responsible Emitters who are at risk of exceeding their baselines should consider how the cost of any emissions reduction activity or mitigation measures may be managed.

For example, they should consider:

- whether their current commercial arrangements need to be reviewed in order to facilitate a pass through of the costs of implementing any mitigation measures;
- paying any civil penalties; or
- acquiring ACCUs to offset net emissions.

What you need to do

Submissions on the Consultation Paper are due by midday AEST on **Monday 27 April 2015**.

This is a key opportunity to provide input on the design and operation of the Safeguard Mechanism.

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