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The Legal Framework for Australia's Carbon Pricing Mechanism: a critique

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Abstract

As part of the Australian Government's Clean Energy Plan, the Government has attempted to harness the legal innovation of the tradeable emissions unit, within a capped carbon trading system, to reduce greenhouse gas emissions. Such an approach promises to send a price signal to the market which will influence emitting behaviours and reduce our emissions in a cost-effective manner. However, if the carbon trading scheme is to successfully achieve cost-effective emissions reductions then the carbon market must be supported by an appropriate legal framework. This paper will consider the key features of the Australian Carbon Pricing Mechanism, including the Carbon Farming Initiative, and critique whether it has all the hallmarks of an effective legal framework to reduce Australia's net greenhouse gas emissions. The likely future of the trading scheme, following the 2013 elections, will also be addressed.

1. The Australian Carbon Pricing Story

Australia has had a rocky road in designing its emissions trading system. Many models have been proposed. However, up until recently those proposals have failed to win passage through the Australian Senate.¹ Australia's political landscape changed dramatically in 2010 with an election that resulted in a hung Parliament. A significant shift in support towards the Australian Greens party left the Greens in the position of sharing the balance of power in the House of Representatives with a number of independent MPs and holding the balance of power in the Senate. In order to form a minority government, Prime Minister Julia Gillard and the Australian Labor party entered into a series of agreements with the Greens party MPs and a number of independent MPs. This included an undertaking to establish the *Multi-Party Climate Change Committee*, comprised of Labor, Greens and Independent MPs, to explore options for implementing a carbon price in Australia. The committee was established in September 2010 and started from the position that a carbon price was a necessary economic reform required to reduce Australia's carbon pollution.² Members of the Australian Coalition party were invited to sit on this committee but declined owing to the conflicting position of their party on the need to price carbon. Their position is that similar levels of emissions reductions can be achieved through "direct" regulatory action rather than relying on the use of taxes or other economic instruments.³ In July 2011, the committee released the *Multi-Party Climate Change Committee Clean Energy Agreement* setting out the agreed framework for putting a price on carbon. This included agreement to the introduction of a "fixed price" for carbon

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¹ Legislation for the implementation of the *Carbon Pollution Reduction Scheme*, an emissions trading scheme, was developed in 2008-2009 by the Rudd Labor Government. However, the bills package was rejected by the Australian Senate twice in 2009. A third attempt to achieve passage of the bills package in May 2010 was abandoned prior to the Senate voting on the bills package owing to very vocal opposition from both the Coalition and the Greens Party. See Durrant N "Australia's Legal Response to Climate Change: business as usual or legal innovation?" 22 (3) *Environmental Law and Management Journal* (2010) pp 105-114.

² Department of Climate Change and Energy Efficiency, "About the Multi-Party Climate Change Committee" <<http://www.climatechange.gov.au/government/initiatives/mpccc/about-mpccc.aspx>> viewed 10 January 2012.

³ The Australian Coalition, "Direct Action Plan on the Environment and Climate Change" 2010.

permits prior to the market transitioning to a fully flexible trading system.⁴ This has, unfortunately led to the Australian scheme being commonly referred to as a “carbon tax”, causing serious political headaches for the Prime Minister who went to the 2010 election promising there would be no carbon tax under a Gillard Government (“the Government”).⁵

Following the agreement of the Multi-Party Climate Change Committee, the Australian Government released the details of its *Clean Energy Plan*. This included the Australian Government’s policy commitment to reduce national carbon emissions to 5 per cent below 2000 levels by 2020 and 80 per cent below 2000 levels by 2050.⁶ The Government’s principal measure for addressing emissions involved the imposition of a price on carbon, in conjunction with a trading mechanism, known as the Carbon Pricing Mechanism.⁷ The legislative package for the implementation of the Carbon Pricing framework was passed in November 2011. The Government also secured passage of legislation to establish an incentive scheme for landholders for the creation and trade of land based carbon offset credits, known as the *Carbon Farming Initiative*.⁸ The Government’s Clean Energy Plan includes a number of additional measures including adjustments to fuel tax credits and excise, at such a rate as to have the same effect as directly applying a carbon price.⁹ The Government will also establish the *Clean Energy Finance Corporation*, supported by AU\$10 billion in funding, to carry out investment in renewable energy, low-pollution and energy efficiency technologies.¹⁰ In addition, the new *Australian Renewable Energy Agency* (ARENA) will administer AU\$3.2 billion in support for research and development, demonstration and commercialisation of renewable energy over a nine year period.¹¹ Despite being called the “Clean Energy Plan”, the plan is silent on additional regulatory measures to promote renewable energy and energy efficiency within Australia, relying instead on the continuation of the existing *Renewable Energy Target Scheme* and the implementation of the *National Strategy on Energy Efficiency*.¹²

2. International Drivers behind Australia’s Legal Response

The domestic response to climate change in Australia is part of a much bigger international endeavour to reduce global atmospheric concentrations of greenhouse gas emissions. This means that our successes and failures at a domestic level will affect the ultimate outcomes of the international community in reducing global levels of greenhouse gases. The *United Nations Framework Convention on Climate Change* (UNFCCC) was signed and ratified by Australia in 1992.¹³ It acknowledged that anthropogenic emissions of greenhouse gases were contributing to adverse climate change and adopted the goal of achieving the stabilisation of greenhouse gas concentrations in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system.¹⁴ The Copenhagen Accord,

⁴ This had been previously called for by the Australian Greens Party as a solution to the deadlock surrounding the failed Carbon Pollution Reduction Scheme. The Australian Greens MPs, ‘Greens Propose Garnaut’s Interim Solution to Break CPRS Deadlock’ and ‘Interim Carbon Price: Proposal for a Transitional Carbon Pricing Mechanism’ (January 2010) <<http://greensmp.org.au>> accessed 20 December 2011.

⁵ Gillard Julia, “There will be no carbon tax under the government I lead” August 16, 2010 <<http://www.abc.net.au/news/2011-06-24/julia-gillards-year-in-quotes/2769610>> viewed 10 January 2012.

⁶ Australian Government, *Securing a Clean Energy Future: The Australian Government’s Climate Change Plan*, (2011), Chapter Two-Targets for Action, <<http://www.cleanenergyfuture.gov.au/wp-content/uploads/2011/07/Consolidated-Final.pdf>> viewed 10 January 2012. [hereinafter “Clean Energy Plan”].

⁷ *Clean Energy Act 2011* (Cth), [hereinafter “Clean Energy Act”].

⁸ *Carbon Credits (Carbon Farming Initiative) Act 2011* (Cth) [hereinafter “CFI Act”].

⁹ This will not apply to domestic fuel users and fuel use associated with agricultural, forestry and fishery activities, Clean Energy Plan, n6, p 29.

¹⁰ Clean Energy Plan, n6, p 63.

¹¹ Clean Energy Plan, n6, p 63; *Australian Renewable Energy Agency Act 2011*(Cth).

¹² Clean Energy Plan, n6, p ix. For a discussion of these mechanisms see Durrant, n1.

¹³ *United Nations Framework Convention on Climate Change*, opened for signature on 4 June 1992, 31 ILM 849 (entered into force on 21 March 1994) [hereinafter “the UNFCCC”].

¹⁴ UNFCCC, “Decision 1/CMP. 15: Copenhagen Accord”(CMP.15, 18 December 2009).

although not an official legal agreement, indicated that to achieve this, the global community should reduce concentrations of emissions to a level that will avoid a more than a 2 degree increase in average surface temperatures across the globe.¹⁵ This is a challenging level of reductions for the global community. The Australian Government's independent expert advisor, Professor Garnaut, has made it clear that Australia needs to play a proportional part in achieving that 2 degree objective, and contributing to a reduction in atmospheric concentrations of carbon dioxide equivalent of 450 parts per million.¹⁶

The Kyoto Protocol to the UNFCCC was signed by Australia in 1997 but not ratified until 2007 when the Rudd Government came to power. Unlike the general duties of the UNFCCC, the Kyoto Protocol contains specific emission reduction targets for each country. For Australia that was an increase of 8 per cent above our reported 1990 emission levels to be achieved by the end of the first commitment period in 2012. Given the number of concessions granted to Australia, including the permitted 8 per cent increase, all indications are that we will meet that target in 2012.¹⁷ It is our predicted strong growth in emissions from 2012 onwards that poses the greatest challenge for the Government.¹⁸

The Kyoto Protocol Mechanisms

The Kyoto Protocol aims to achieve the global reduction of greenhouse gas emissions by committing Annex-1 Parties, including Australia, to binding targets to limit or reduce their aggregate anthropogenic greenhouse gas emissions.¹⁹ It aims to achieve emissions reductions globally at the place where it is most cost-effective to do so, resulting in the creation of a number of flexibility mechanisms encompassing international emissions trading and the generation of credits from eligible sequestration and abatement projects.

Each Annex-1 Party has been assigned a number of Assigned Amount Units (AAUs) calculated in accordance with its permitted level of emissions for the first commitment period from 2008 to 2012.²⁰ Once deemed eligible to trade, each Annex-1 Party may purchase additional AAUs through the international emissions trading market.²¹ Annex-1 Parties can create additional units, known as Certified Emission Reduction Units (CERs), through the implementation of eligible emissions reductions projects in developing countries under the Clean Development Mechanism (CDM).²² Emissions reduction projects may also be implemented by Annex-1 Parties, in other Annex-1 Party countries, under the Joint Implementation mechanism (JI).²³ In that case, the host country will cancel the requisite number of units in its holding account and issue the same number of Emission Reduction Units (ERUs).²⁴ While there is significant flexibility in the use of these mechanisms, they are only intended to be used as a supplement to direct domestic action to reduce or mitigate actual greenhouse gas emissions.²⁵ Accordingly, domestic

¹⁵ *Kyoto Protocol to the United Nations Framework Convention on Climate Change*, opened for signature 16 March 1998 (entered into force on 16 February 2005) [hereinafter "the Kyoto Protocol"].

¹⁶ Garnaut R, "Carbon Pricing and Reducing Australia's Emissions: Update Paper No 6" (Garnaut Climate Change Review Update 2011, 2011) 2.

¹⁷ Australian Government, "Australia's Emissions Reduction Targets" (Department of Climate Change and Energy Efficiency) 1 <<http://www.climatechange.gov.au/government/reduce/national-targets/~media/government/reduce/NationalTarget-Factsheet-20111201-PDF.pdf>> viewed 10 January 2012.

¹⁸ Ibid.

¹⁹ Kyoto Protocol, art 3(1).

²⁰ UNFCCC, "Decision 13/CMP.1: Modalities for the Accounting of Assigned Amounts under Article 7, paragraph 4, of the Kyoto Protocol: Annex: Modalities for the accounting of assigned amounts under Article 7, paragraph 4, of the Kyoto Protocol"(FCCC/KP/CMP/2005/8/Add.2) Section I (B) at [5].

²¹ Kyoto Protocol, art 17.

²² Kyoto Protocol, art 12.

²³ Kyoto Protocol, art 6.

²⁴ Kyoto Protocol, art 6.1(b).

²⁵ UNFCCC, "Decision 15/CP.7 on Principles, nature and scope of the mechanisms pursuant to Articles 6, 12 and 17 of the Kyoto Protocol" (FCCC/CP/2001/13/Add.2, 21 January 2002) at 2; Kyoto Protocol, arts 5,7,8.

actions must constitute a “significant element” of the efforts made by each party to meet its target under the Kyoto Protocol.²⁶ This principle will be carried over into the second commitment period of the Kyoto Protocol which will extend from 1 January 2013 to 31 December 2017 (or 31 December 2020 - depending on the decision of the parties).²⁷ Work on the quantified emission limitation or reduction objectives (QELROs) for that second commitment period is also continuing.²⁸ In the meantime, the parties have agreed to develop a legal instrument, or agreed outcome with legal force, that would be applicable to all parties to the UNFCCC and would come into effect from 2020.²⁹

3. Setting The Carbon Price

The Australian Carbon Pricing Mechanism is intended to send a price signal to the market to influence emitting behaviours and reduce Australia’s national emissions in an environmentally effective and cost-effective manner.³⁰ Because of this, the level of that carbon price will play a central role in achieving emissions reductions. Unlike the previous carbon trading proposal, the *Carbon Pollution Reduction Scheme*, the Carbon Pricing Mechanism will initially operate as a fixed charge for tradeable permits.³¹ In the fixed price stage, starting on 1 July 2012, the carbon price will start at AU\$23 a tonne and increase to AU\$24.15 in 2013-14 and AU\$25.40 in 2014-15.³² During this phase, there will be no limit on the number of permits available at the relevant fixed price. Permits will be both freely allocated and available for purchase.³³ However, all permits purchased at the fixed price will be automatically surrendered and cannot be traded or banked for future use.³⁴

On 1 July 2015, the Carbon Pricing Mechanism is intended to transition to a flexible price period. For the first three years the price will not truly flexible as a price ceiling and price floor will apply.³⁵ The Government’s independent expert advisor, Professor Garnaut warned against the use of a price ceiling or price floor, cautioning that setting the ceiling or floor would be inherently arbitrary and would damage greatly the normal operation of the market.³⁶ In particular, although a price ceiling would limit the cost of mitigation it would render “unreliable the scheme’s capacity to deliver emissions reductions in relation to targets.”³⁷ Despite this, a price ceiling and floor will be used in the early years of the Carbon Pricing Mechanism. The price ceiling will be initially set at AU\$20 above the expected international price and will rise by 5 per cent in real terms each year.³⁸ The price floor will be set at AU\$15 rising annually by 4 per cent in real terms.³⁹ With the exception of units under the Carbon Farming Initiative (discussed later) Australian Carbon Units (ACUs) will not be permitted to be exported internationally while the domestic

²⁶ Ibid.

²⁷ UNFCCC, “Emissions Trading and the Project-Based Mechanism” (CMP.7, December 2011, advance unedited version), [1]; UNFCCC, “Outcome of the Work of the Ad Hoc Working Group on Further Commitments for Annex 1 Parties under the Kyoto Protocol at its sixteenth session” (CMP.7, December 2011, advance unedited version), [1].

²⁸ UNFCCC, “Outcome of the Work of the Ad Hoc Working Group on Further Commitments for Annex 1 Parties under the Kyoto Protocol at its sixteenth session” (CMP.7, December 2011, advance unedited version), [4].

²⁹ UNFCCC, “Establishment of an Ad Hoc Working Group on the Durban Platform for Enhanced Action” (CP.17, December 2011, advance unedited version) [4]. Work on this agreement will commence in the first half of 2012.

³⁰ *Commentary on the Clean Energy Bill 2011*, Australian Government Department of Climate Change and Energy Efficiency, 11 (2011) [hereinafter ‘*Clean Energy Commentary*’].

³¹ *Clean Energy Commentary*, n30, p 12.

³² *Clean Energy Plan*, n6, pp vii; 103.

³³ *Clean Energy Plan*, n6, p 103.

³⁴ *Clean Energy Plan*, n6, p 103.

³⁵ *Clean Energy Commentary*, n30, p 12.

³⁶ *Final Report to the Commonwealth, State and Territory Governments of Australia*, Garnaut Climate Change Review, 314 (2008) [hereinafter “Garnaut Review”], p 335.

³⁷ Garnaut Review, n36, 335.

³⁸ *Clean Energy Plan*, n6, p xiii.

³⁹ *Clean Energy Plan*, n6, p xiii.

price floor and price ceiling is in place.⁴⁰ This prohibition will be lifted once those price constraints are removed.⁴¹ During the flexible price period, permits under the Carbon Pricing Mechanism will be allocated by auctioning.⁴² Unlimited banking of permits will be allowed in the flexible price period. However, only limited borrowing of permits will be permitted.⁴³

4. Setting the Emissions Reduction Trajectory and Market Caps

During the fixed price period there will be no limit or cap placed on Australia's greenhouse gas emissions. As part of the transition to the flexible price period, the Government will need to determine the market cap and the limit to be placed on the number of permits released to the market. Ideally, this cap should align with the short and long-term policy commitments made by the Government to reduce greenhouse gas emissions. However, these in turn, should align with international agreement and follow the advice of the *Intergovernmental Panel on Climate Change* and other expert advisors on the necessary global cuts for avoiding adverse climate change. The Government has announced the establishment of an independent *Climate Change Authority* to advise on pollution caps and progress towards meeting targets and to undertake reviews of the Carbon Pricing Mechanism, with the first report due in 2014.⁴⁴ However, it should be noted that this advice is not binding on the Government and it has stated firmly that the Government will be making all final decisions.⁴⁵ By the deadline of 31 May 2014, the Government is required to table regulations in Parliament setting the annual pollution caps for the years 2015- 2019 with the annual cap for 2020 to be set in 2016.⁴⁶ In setting the pollution caps the Government must take into account, among other matters, voluntary action including the use of Green Power and voluntary cancellation of units.⁴⁷

Ongoing uncertainty regarding the scheme caps is a significant flaw in the design of the emissions trading scheme for Australia. Ideally, the duty to reduce emissions, and corresponding scheme caps on emissions, should be determined well ahead of the other legal features of the scheme, such as allocations, compensation measures and offset provisions, all of which have the potential to conflict with or undermine the allocated cap.

Setting the quantitative cap can be a troublesome political process not only because of competing social, economic and environmental needs and priorities but also owing to the fact that targets must be sufficiently flexible to adapt to 'differential economic growth, uncertain technological change and evolving science'.⁴⁸ A challenge which is well-demonstrated by the Kyoto Protocol, "which set its targets 13 years before the date on which controls became effective .. and used baseline emissions from 20 years before the control period."⁴⁹ Without any action to reduce emissions, the Government estimates that, in

⁴⁰ Unless an appropriate bilateral linkage is in place.

⁴¹ Clean Energy Commentary, n30, p 92.

⁴² Clean Energy Plan, n6, p 104.

⁴³ Clean Energy Plan, n6, p 104. in any particular compliance year, a liable entity can surrender permits from the following vintage year to discharge up to 5 per cent of their liability

⁴⁴ Clean Energy Plan, n6, p xiii; as established by the *Climate Change Authority Act 2011* (Cth).

⁴⁵ Clean Energy Plan, n6, p 27.

⁴⁶ Clean Energy Act, s 16; Clean Energy Plan, n6, p 26, 103. In the event the regulations are rejected by the Parliament, the Act contains default pollution caps (in line with the 5 per cent reduction target) for the years 2015 onwards, Clean Energy Act, Part Two.

⁴⁷ Clean Energy Act, s 16; Clean Energy Plan, n6, pp103, 108. A Pledge Fund will be established to help individuals access the carbon market and voluntarily cancel emissions units.

⁴⁸ Nordhaus WD, 'The Many Advantages of Carbon Taxes' in Marsh I (ed), *Growth 61 A Taxing Debate: Climate Policy Beyond Copenhagen* (CEDA, Melbourne, 2009), 64 at p 66.

⁴⁹ Nordhaus, n48, p 66.

2020, Australia's emissions will be 24 per cent above 2000 levels.⁵⁰ As noted, the Government has made a policy commitment to reduce national emissions by 5 per cent below 2000 levels by 2020 and 80 per cent below 2000 levels by 2050.⁵¹ In addition, the Government has also made conditional commitments to reduce emissions by up to 15 per cent⁵² or 25 per cent⁵³ below 2000 levels depending on the scale of global action agreed to by the international community.⁵⁴ Both of these commitments are dependent on the inclusion of avoided deforestation (REDD) and the land sector, including soil carbon, as part of the international agreement under the UNFCCC and/or Kyoto Protocol.

One of the most important features of an effective "cap and trade" market is the presence of a comprehensive cap or limit on the number of permits released to the market.⁵⁵ This cap acts as a volumetric control to ensure that greenhouse gas emissions, and atmospheric concentrations, will decline in accordance with the global reduction trajectory.⁵⁶ The limit placed on available permits will create a "scarcity value" or price signal to modify the emitting behaviours of consumers and industry.⁵⁷ During the flexible-price period and until 2020, at least 50 per cent of a liable party's compliance obligation must be met through the use of Australian units or credits rather than through the purchase of international units.⁵⁸ This, in effect, means that the prescribed "market cap" for Australia is increased by the permitted 50 per cent import of international units. Furthermore, during the fixed-charge period, liable entities will be permitted to surrender up to 5 per cent of eligible credits from the Carbon Farming Initiative to satisfy their liabilities under the Carbon Pricing Mechanism.⁵⁹ Once the flexible-charge period commences,

⁵⁰ Australian Government, "Australia's Emissions Reduction Targets" (Department of Climate Change and Energy Efficiency) 1 <http://www.climatechange.gov.au/government/reduce/national-targets/~media/government/reduce/NationalTarget-Factsheet-20111201-PDF.pdf> viewed 10 January 2012.

⁵¹ Clean Energy Plan, n6, Chapter Two-Targets for Action.

⁵² The conditions are that there must be an international agreement where *major developing economies* commit to substantially restrain emissions and *advanced economies* take on commitments comparable to Australia's including: global action on track to stabilisation between 510-540ppm CO₂-e; advanced economy reductions in aggregate, in the range of 15 – 25% below 1990 levels; substantive measurable, reportable and verifiable commitments and actions by major developing economies, and progress toward inclusion of forests (REDD) and the land sector, Australian Government, "Australia's Emissions Reduction Targets" (Department of Climate Change and Energy Efficiency) 2 <http://www.climatechange.gov.au/government/reduce/national-targets/~media/government/reduce/NationalTarget-Factsheet-20111201-PDF.pdf> viewed 10 January 2012.

⁵³ The conditions are the achievement of comprehensive global action capable of stabilising CO₂-e concentrations at 450ppm CO₂-e or lower with *major developing economies* slowing the growth and then reducing their emissions and *advanced economies* taking on reductions and commitments comparable to Australia. This includes comprehensive coverage of gases, sources and sectors, with inclusion of forests (REDD) and the land sector (including soil carbon initiatives (e.g. bio char) if scientifically demonstrated); a clear global trajectory, where the sum of all economies' commitments is consistent with 450ppm CO₂-e or lower, and with a nominated early deadline year for peak global emissions not later than 2020; advanced economy reductions, in aggregate, of at least 25% below 1990 levels by 2020; major developing economy commitments that slow emissions growth and then reduce their absolute level of emissions over time, with a collective reduction of at least 20% below business-as-usual by 2020 and a nomination of a peaking year for individual major developing economies, Australian Government, "Australia's Emissions Reduction Targets" (Department of Climate Change and Energy Efficiency) 2 <http://www.climatechange.gov.au/government/reduce/national-targets/~media/government/reduce/NationalTarget-Factsheet-20111201-PDF.pdf> viewed 10 January 2012.

⁵⁴ Clean Energy Plan, n6, p 14

⁵⁵ Garnaut Review, n36, p 314.

⁵⁶ Garnaut Review, n36, pp 317, 322.

⁵⁷ Garnaut Review, n36, pp 311-312.

⁵⁸ Clean Energy Commentary, n30, p 33; Clean Energy Act, Part 6.

⁵⁹ Subject to the regulations, these will include Kyoto-compliant carbon credits under the CFI and non-Kyoto compliant carbon credits issued for eligible offsets projects where a Kyoto-compliant credit would have been issued if the reporting period had ended before the Kyoto abatement deadline (as defined under the CFI Act), Clean Energy Act, s. 5; Clean Energy Commentary, n30, p 119.

there will be no restrictions on the number of eligible Carbon Farming Initiative credits able to be surrendered under the Carbon Pricing Mechanism.⁶⁰

The Government's advisor, Garnaut, has stressed that "the integrity of the trajectory and the overall emissions budget is paramount in order to satisfy the scarcity principle."⁶¹ This increased supply of credits, above the 'cap', could distort the price signal and undermine the environmental effectiveness and economic efficiency of the Australian carbon market.⁶² As Garnaut has cautioned, "most damaging of all would be measures that rendered ineffective the credibility of the quantitative restriction (the emissions limit) on which the entire emissions trading scheme is predicated."⁶³

5. Scheme Coverage: Identifying the Liable Entities

A comprehensive and well-designed emissions trading scheme must clearly identify who is covered by the scheme, which sectors and which greenhouse gases?⁶⁴ To be compatible with the international climate change market, the Australian scheme should extend to all six greenhouse gases identified under the Kyoto Protocol. However, the Carbon Pricing Mechanism will cover only four of the six greenhouse gases counted under the Kyoto Protocol, that is, carbon dioxide, methane, nitrous oxide and perfluorocarbons from aluminium smelting.⁶⁵ High global warming potential synthetic greenhouse gases (other than perfluorocarbons from aluminium smelting) will be excluded from the Carbon Pricing Mechanism. Instead they will be subject to an equivalent carbon price using import and manufacture levies under the existing *Ozone Protection and Synthetic Greenhouse Gas Management Act 1989* (Cth).⁶⁶ From 1 July 2013, incentives will also be provided for the destruction of waste synthetic greenhouse gases, including ozone depleting substances, that are recovered at the end-of-life.⁶⁷

A primary concern will be identifying those sectors to be included in the Carbon Pricing Mechanism. Broadening the scope of trading schemes will tend to lower costs and reduce price volatility.⁶⁸ While a large number of participants will improve the functioning of the overall market this also involves higher administration and monitoring costs. The number of participants must be able to be managed administratively as well as being able to accurately monitor and verify the emissions from each liable entity. Accordingly to Garnaut, coverage of the Australian emissions trading scheme should be as broad as possible within practical constraints imposed by measurability and transaction costs in order to, "provide an incentive for emissions reductions in all sectors according to lowest-cost mitigation opportunities, maximise market liquidity and stability" and to avoid distortions.⁶⁹ Garnaut noted that emissions from stationary energy, transport, waste, and industrial processes should all be included in an emissions trading scheme with the inclusion of agriculture and forestry once measurement and monitoring concerns were resolved.⁷⁰ This broad coverage would:

- i. provide an incentive for emissions reductions in all sectors according to lowest-cost mitigation principles;
- ii. maximise market liquidity and stability;
- iii. distribute costs of the scheme in ways that minimise distortions in resource allocation; and

⁶⁰ Clean Energy Commentary, n30, p 94.

⁶¹ Garnaut Review, n36, p 325.

⁶² Garnaut Review, n36, p 311.

⁶³ Garnaut Review, n36, p 314.

⁶⁴ Garnaut Review, n36, p 317.

⁶⁵ Clean Energy Plan, n6, p 104.

⁶⁶ Clean Energy Plan, n6, p 105

⁶⁷ Clean Energy Plan, n6, p 105

⁶⁸ Garnaut Review, n36, p 338.

⁶⁹ Garnaut Review, n36, p 326.

⁷⁰ Garnaut Review, n36, p 358.

- iv. facilitate integration with other markets.⁷¹

The Carbon Pricing Mechanism will apply to approximately 500 entities across the stationary energy sector, select areas of the transport sector (domestic aviation, domestic shipping, rail), industrial processes, non-legacy waste⁷², and fugitive emissions.⁷³ To be a liable entity under the Carbon Pricing Mechanism, entities must generally be in operational control of facilities which have a total amount of covered emissions of 25,000 tonnes of carbon dioxide equivalent per annum or more.⁷⁴

Transport fuels will be excluded from the Carbon Pricing Mechanism. Where applicable, an equivalent carbon price will be applied through changes in fuel tax credits or excise.⁷⁵ However, a carbon price will not apply to household transport fuels, light vehicle business transport and off-road fuel use by the agriculture, forestry and fishing industries.⁷⁶

Agriculture and forestry are excluded from the scheme despite Garnaut's recommendation that the land sector should be included once measurement and monitoring concerns were resolved.⁷⁷ This is a significant point of difference between the Carbon Pricing Mechanism and the Carbon Pollution Reduction Scheme (CPRS). In the CPRS, forest landholders were able to "opt in" eligible reforestation activities and generate permanent tradable credits from net sequestration.⁷⁸ Where sequestration levels dropped, the project proponent was a liable entity and required to surrender permits for its net emissions. By including reforestation as a liable entity within the CPRS, the Government had sought to avoid the administrative issues and compliance costs associated with ensuring that forestry credits were additional to business as usual and permanently maintained.⁷⁹ Under the Carbon Pricing Mechanism, offset credits will be generated in Australia under a separate Carbon Farming Initiative, discussed further below.

6. Assistance Measures for Liable Entities and Households

A controversial aspect of Australia's emissions trading scheme has been the provision of transitional assistance to emissions-intensive-trade-exposed industries through the issue of free allowances or other payments.⁸⁰ The principle behind this assistance is to protect Australian firms from the adverse impacts of a carbon price in those industries where overseas trade competitors are not subject to similar carbon constraints or carbon pricing.⁸¹ However, Garnaut has warned against the "arbitrary nature" of such assistance measures and warned, in particular, against the allocation of free permits in *any* circumstances.⁸² His firm advice has been that all permits should be auctioned with assistance provided to

⁷¹ Garnaut Review, n36, p 326.

⁷² Landfill facilities will not be liable for emissions that arise from waste deposited prior to 1 July 2012, Clean Energy Plan, n6, p 105.

⁷³ Clean Energy Act, Part 3.

⁷⁴ Clean Energy Act, Part 3. Where a facility is operated by an Unincorporated Joint Venture and no one person has operational control over the facility, the emissions liability for that facility will instead be allocated between the joint venture participants in proportion to their interest in the facility. Clean Energy Plan, n[], p 105.

⁷⁵ Clean Energy Plan, n6, p xiii.

⁷⁶ Clean Energy Plan, n6, p xiii.

⁷⁷ Garnaut Review, n36, p 358; *Update Paper No 4: Transforming Rural Land Use*, Garnaut Climate Change Review, 49 (2011).

⁷⁸ *Carbon Pollution Reduction Scheme Bill 2010* (Cth), Part 10 [hereinafter "CPRS"].

⁷⁹ *Carbon Pollution Reduction Scheme Green Paper*, Australian Government, Department of Climate Change, 127 (2008).

⁸⁰ Garnaut Review, n36, p 317.

⁸¹ Garnaut Review, n36, p 341.

⁸² Garnaut Review, n36, p 332.

emissions-intensive-trade-exposed industries using a crediting mechanism rather than freely allocated permits.⁸³

The Government has determined that certain emissions-intensive-trade-exposed industries will be constrained in their ability to pass on the price of permits to their consumers and that transitional assistance is warranted.⁸⁴ This assistance package includes the AU\$9.2 billion *Jobs and Competitiveness Program* which will provide support to emissions-intensive and trade-exposed activities that generate over 80 per cent of emissions within the manufacturing sector.⁸⁵ Eligibility is based on the historic industry average baseline for carbon emissions from these sectors. The Government has acknowledged that the specific intention of this assistance is to “shield eligible businesses from the full impact of a carbon price.”⁸⁶ Eligible activities for assistance include aluminum production, steel manufacturing, pulp and paper manufacturing, glass making, cement production and petroleum refining.⁸⁷

Despite the recommendations of Garnaut, this assistance will be provided in the form of free permits. The most emissions-intensive and trade-exposed activities will initially be eligible for 94.5 per cent shielding from the carbon price.⁸⁸ Those activities assessed as having a lower risk of carbon leakage will be eligible for 66 per cent shielding from the carbon price.⁸⁹ Liquefied Natural Gas projects will also receive a supplementary allocation of permits with an effective assistance rate of 50 per cent of the carbon price.⁹⁰ Those assistance rates will be reduced by a “carbon productivity contribution” of 1.3 per cent per year, this is designed to ensure that incentives increase over time, in these industries, to reduce their carbon emissions.⁹¹ In addition to this assistance, the steel manufacturing industry will also receive financial assistance through an AU\$300 million five year *Steel Transformation Plan*, designed to encourage investment and innovation in the Australian steel manufacturing industry.⁹² The Government has further announced the Energy Security Fund through which approximately AU\$5.5 billion in assistance, in the form of free permits, cash incentives and loans, to highly emissions-intensive coal-fired generators.⁹³ The intention behind the award of these free permits is to provide transitional assistance to “help generators that face sizeable losses in the value of their assets and support investor confidence, and underpin the investment in generation assets that is required to ensure that Australia’s future energy security needs are met.”⁹⁴ Assistance is conditional on the generator providing the Minister with a *Clean Energy Investment Plan* setting out the plans (if any) for reducing the emissions-intensity of the generation complex.⁹⁵ The *Energy Security Fund* will also be used to negotiate the closure of around 2,000 megawatts of highly emissions-intensive coal-fired generation capacity, across Australia, by the year 2020 generator.⁹⁶ A

⁸³ Garnaut Review, n36, pp 345, 332.

⁸⁴ CPRS, Part 8.

⁸⁵ Clean Energy Act, Part 7; Clean Energy Plan, n6, p 54.

⁸⁶ Clean Energy Plan, n6, p 55.

⁸⁷ Clean Energy Plan, n6, p 54.

⁸⁸ Where the historic industry average baseline emissions are > 2000 tonnes CO2 equivalent/AU\$ million revenue. Clean Energy Plan, n6, p 55.

⁸⁹ Where the historic industry average baseline emissions are > 1000-1999 tonnes CO2 equivalent/AU\$ million revenue. Clean Energy Plan, n6, p 55.

⁹⁰ Clean Energy Plan, n6, p 55.

⁹¹ Clean Energy Plan, n6, p 55.

⁹² *Steel Transformation Plan Act 2011* (Cth); Clean Energy Plan, n6, p 133. In addition, the industry will benefit from a 10 per cent increase in its emissions baseline for the production of certain steel products linked with national infrastructure.

⁹³ Clean Energy Act, Part 8; Clean Energy Plan, n6, p 71.

⁹⁴ Clean Energy Act, s159.

⁹⁵ Clean Energy Act, Part 8, Division 5.

⁹⁶ Clean Energy Plan, n6, p 71.

generator will not be able to gain access to the free permits under the *Clean Energy Act 2011* (Cth) once a closure contract is in force.⁹⁷

The Government also announced an additional *Coal Sector Jobs Package* which includes AU\$1.3 billion financial assistance over 6 years for coal mines with high levels of fugitive emissions, based on historical emissions intensity data.⁹⁸ This is intended to protect jobs while those “gassy mines” investigate options for reducing their fugitive emissions. Finally, the Government will also be introducing assistance to support households.⁹⁹ The Household Assistance Measures program is comprised of an AU\$8 billion tax reform package, including AU\$7 billion of tax cuts, to shield households from an increase in the cost of living from the introduction of the carbon price as well as increases in pensions, allowances and benefits.¹⁰⁰

As can be seen from the preceding overview, it is clear that Australia’s Carbon Pricing Mechanism will come hand in hand with significant measures to ease the initial price impact of the pricing mechanism on Australian industry, households and the economy. While some assistance to low income and vulnerable individuals and sectors may be warranted, these broad scale buffers are much more worrying from a design perspective. The Carbon Pricing Mechanism is designed to create a pollution liability. It is this obligation to “pay a price” for carbon emissions that is intended to send a price signal to the community to influence our emitting behaviours and reduce emissions. The principles of environmental law tell us that the polluter should be the one held responsible for the environmental and social cost of emitting pollution and causing harm. Providing a significant number of free permits or providing access to a large number of low cost permits may weaken this necessary price signal and prevent this economic instrument from achieving emissions reductions. Clearly the Government does not agree with this point of view, or with the advice of Garnaut. The Government has stated not only that these are necessary transitional measures but also that the incentive to reduce emissions will remain despite the provision of assistance. In particular, the allocation of free permits is said to provide industry with an incentive to carry out changes in their emitting practices. This is because those holders of freely allocated permits who find themselves holding excess permits (given that allocations are based on historic average emissions) will be able to sell those permits back to the Government at the current market price.¹⁰¹ However, the real effect of these free allocations has been the phenomenal use of political lobbying and public protests by industry to emphasise the drastic impacts of the carbon price on the sustainability of their sectors in an attempt to increase the assistance measures provided by the Government.

7. Personal Property and the Tradable Permit

One of the most important features of an effective Carbon Pricing Mechanism is the ability to trade permits during the flexible price period. Tradability of permits requires a number of matters to be addressed including that:

- i. permit characteristics and the benefits they bestow are unambiguous;
- ii. the terms and conditions of trade are commonly understood;
- iii. those wanting to participate have ready access to the market;

⁹⁷ Clean Energy Act, Part 8, Division 6.

⁹⁸ *Clean Energy Regulations 2011* (Cth); Clean Energy Plan, n6, p 134. Eligible coal mines will be those mines that had a fugitive emissions intensity in 2008-09 of at least 0.1 tonne of carbon dioxide equivalent per tonne of saleable coal produced. Assistance will be provided to eligible coal mines for up to 80 per cent of their fugitive emissions exposure above that 0.1 threshold.

⁹⁹ *Clean Energy (Household Assistance Amendments) Act 2011*(Cth).

¹⁰⁰ Clean Energy Plan, n6, p xv.

¹⁰¹ The holders of freely allocated permits will be able to sell them to the Government from 1 September of the compliance year in which they were issued until 1 February of the following compliance year; Clean Energy Plan, n6, p 103; Clean Energy Act, Part 4, Division 5.

- iv. transactions can be secured at minimal cost; and
- v. offer and bid prices are transparently available.¹⁰²

The effectiveness of the proposed Australian Carbon Pricing Mechanism could be seriously undermined by the absence of adequate legal reform to ensure the optimal operation of the carbon market including provisions to ensure that property rights in the tradable credits are fully defined.¹⁰³ In order to be of financial value, the credits must be recognised and protected as “property” by the legal system in which the credit is held. This means that the legal instrument must be clearly defined and appropriately protected by rules securing ownership, transfer and other dealings.¹⁰⁴ Without the presence of these legal attributes, the allocated legal instrument will be more akin to regulatory property, with limited property protections, than a commodity and will attract a lesser value with repercussions for the effectiveness of the market system.¹⁰⁵

The Clean Energy Act intends to establish carbon permits which are “personal property” and “transmissible by assignment, by will and by devolution by operation of law.”¹⁰⁶ Carbon credits will be held in the Commonwealth Australian National Registry and ownership and transfer will be subject to the requirements of the *Clean Energy Act 2011* (Cth) and the *Australian National Registry of Emissions Units Act 2011* (Cth). The Clean Energy Act states that that the registered holder of a carbon unit is the legal owner of the unit and may deal with the unit as its legal owner and give good discharges for any consideration for any such dealing.¹⁰⁷ However, the Act goes on to specifically limit the protection provided by that provision to only those persons who deal with the registered holder of the unit as a purchaser in good faith for value; and without notice of any defect in the title of the registered holder.¹⁰⁸ Future provisions may also enable the registration in the Australian National Registry of equitable interests in relation to carbon units - provided it is not a security interest under the *Personal Property Securities Act 2009* (Cth).¹⁰⁹ The legislation otherwise states that, for the avoidance of doubt, the Act does not affect the creation of; any dealings with; the enforcement of; or equitable interests in relation to a carbon unit.¹¹⁰ As a result, it appears that there will be dealings with these carbon units that are not subject to the Commonwealth registry but instead subject to the principles and requirements of the Australian State and Territory property law regimes. No additional legal reform has been proposed to clarify the legal treatment of these carbon units by the existing property law systems of the States and Territories. Those schemes vary significantly and it is possible that not all of these jurisdictions will recognise and protect this new form of property in an effective manner. The legal uncertainties created by this could affect the inherent financial value of these instruments within the market system as well as introducing additional transaction costs for market participants.¹¹¹ These concerns are magnified when we consider that the Government is intending to allow international trade in these legal instruments meaning ownership rights will vary depending on the international jurisdiction in which the permit is created and legal recognition of the property rights of the holder of the permit in the overseas jurisdiction in which the permit is held. By default, this will necessitate greater reliance on due diligence prior to purchase, and reliance on contractual warranties at the point of sale, to provide greater certainty and protection to the legal interests of the carbon credit holder.

¹⁰² Garnaut Review, n36, p 324.

¹⁰³ Garnaut Review, n36, p 331.

¹⁰⁴ Yandle B, "Grasping for the Heavens: 3-D Property Rights and the Global Commons" (1999 -2000) 10 *Duke Environmental Law & Policy Forum* 13 at p 15.

¹⁰⁵ For a discussion of *commodification* in the water context see Gray J, "Legal Approaches to the Management and Regulation of Water from Riparian Rights to Commodification" (2006)1(2) *Transforming Cultures eJournal* 64.

¹⁰⁶ Clean Energy Act, s103.

¹⁰⁷ Clean Energy Act, s103A(1).

¹⁰⁸ Clean Energy Act, s103A(2).

¹⁰⁹ Clean Energy Act, s109A.

¹¹⁰ Clean Energy Act, s110.

¹¹¹ Garnaut Review, n36, p 324.

8. Scheme Governance: Monitoring and Reporting

Scheme governance will also have implications for the efficiency, stability and credibility of any future Australian emissions trading scheme. The effectiveness of the market as an innovative policy tool will require that appropriate monitoring and verification of the creation and trade of emissions instruments takes place as well as ensuring the imposition of sanctions for any identified non-compliances.¹¹² Consequently, transparent, credible and efficient reporting of emissions will be an essential component of any effective trading scheme.¹¹³ However, monitoring a high number of participants will require significant resourcing of Government departments with appropriate expertise. There is also the risk that vested interests may attempt to place pressures on Government to favour them in administrative decisions. Because of these factors, Garnaut has stressed that the integrity, efficiency and effectiveness of the Carbon Pricing Mechanism would require “the establishment of an independent carbon bank with all the necessary powers to oversee the long-term stability of the scheme.”¹¹⁴ In response, the Government announced the establishment of the *Clean Energy Regulator* to administer the Carbon Pricing Mechanism, Carbon Farming Initiative, national renewable energy target and the *National Greenhouse and Energy Reporting Act 2007* (Cth) (NGER Act).¹¹⁵

Monitoring and reporting obligations are implemented in Australia through a separate scheme. Under the NGER Act, a controlling corporation must apply to be registered if the corporation’s group of facilities meets one or more of the thresholds for a financial year.¹¹⁶ A registered corporation, or holder of a reporting transfer certificate,¹¹⁷ must provide a report to the regulator for each relevant financial year.¹¹⁸ The report must address the greenhouse gas emissions, energy production and energy consumption for the reporting year and be based on the methods determined by the Minister.¹¹⁹ Failure to comply with the reporting requirements of the NGER Act may result in civil and pecuniary penalties for both the registered corporation and the chief executive officer (CEO) of the corporation.¹²⁰

It is critical that appropriate penalties and liabilities are imposed by the regulator to identified cases of non-compliance with the surrender requirements of the Carbon Pricing Mechanism. That penalty should be significantly higher than the market price of the permit in order to act as a proper deterrent. To ensure that the aggregate cap is not exceeded, there should also be imposed an obligation to “make good” the excess emissions and to acquire and surrender emissions instruments from the market.¹²¹ Under the Carbon Pricing Mechanism, emissions obligations that are not met through the surrender of eligible emissions units must be met by paying an emissions charge for each tonne of carbon dioxide equivalent that has not been surrendered.¹²² However, no make good provision has been included in the Carbon

¹¹² Tietenberg T et al, 'International Rules for Greenhouse Gas Emissions Trading: Defining the principles, modalities, rules and guidelines for verification, reporting and accountability' (UNCTAD/GDS/GFSB/Misc.6, United Nations Conference on Trade and Development, 1999), 53, at p 84.

¹¹³ Garnaut Review, n36, p 328.

¹¹⁴ Garnaut Review, n36, p 321.

¹¹⁵ Clean Energy Plan, n6, p 34. Established by the *Clean Energy Regulator Act 2011* (Cth).

¹¹⁶ *National Greenhouse and Energy Reporting Act 2007* (Cth) [hereinafter “NGER Act”], s12. Those thresholds are generally 50 kilotonnes or more of greenhouse gases emitted from the operation of facilities under the operational control of entities; 200 terajoules or more of energy produced from the operation of facilities under the operational control of entities and 200 terajoules or more of energy consumed from the operation of facilities under the operational control of entities. The threshold is also triggered where an individual facility within a group causes emission of greenhouse gases of 25 kilotonnes or more; production of energy of 100 terajoules or more; or consumption of energy of 100 terajoules or more. NGER Act, s13.

¹¹⁷ Which has the effect of transferring liability from the corporation with operational control to a third party.

¹¹⁸ NGER Act, s 19.

¹¹⁹ NGER Act, s 19. *National Greenhouse and Energy Reporting (Measurement) Determination 2008* (Cth).

¹²⁰ NGER Act, Part 5.

¹²¹ A similar approach was considered in the Garnaut Review, n36, pp 17, 44.

¹²² Clean Energy Plan, n6, p 107.

Pricing Mechanism. During the fixed price period, the emissions charge for the surrender obligations will be 1.3 times the fixed price for permits (AU\$29.90 for 2012-13, AU\$31.40 for 2013-14 and AU\$33.00 for 2014-15).¹²³ During the flexible price period, the emissions charge for any shortfall will be 200 per cent of the benchmark average auction charge for the previous financial year.¹²⁴

9. The Creation and Use of Offset Credits from Forestry and Agriculture

To be compatible with the United Nations and meet Australia's emission reduction obligations, the Government should be seeking to design its domestic scheme to be consistent with the rules set under the Kyoto Protocol for the recognition and treatment of sequestration activities. This includes ensuring that biological sequestration (biosequestration) offsets meet the international prerequisites of environmental credibility, namely, that they are additional to business as usual, independently verified and that they provide a permanent emissions abatement.¹²⁵ However, these standards have not been adhered to in the Australian Carbon Farming Initiative.

The Carbon Farming Initiative is an economic incentive scheme designed to enable farmers and other land managers to undertake eligible offsets projects and to be rewarded by additional income from the sale of carbon credits generated under the scheme. The types of project permitted under the scheme will include both Kyoto-compliant and non-Kyoto-compliant activities, including emission-avoidance offsets projects (agricultural, landfill, introduced-animals) and sequestration offsets projects (living biomass, dead organic matter, soil).¹²⁶ Methodologies are in the process of being developed for the Carbon Farming Initiative and these will identify the applicable measurement and monitoring protocols and other technical requirements for the different project types.

A diverse range of methodologies have been released for public consultation to date. These include reforestation; savanna-fire management; landfill gas recovery; manure management in intensive livestock farming (piggeries); and, rather unusually, feral animal management (camel culling).¹²⁷ Future methodologies are likely to address native-forest protection projects (avoided deforestation), soil-carbon sequestration, and biochar.¹²⁸ The Carbon Farming Initiative will generate Kyoto-compliant or non-Kyoto-compliant tradeable credits depending on the type of project and its eligibility under the Kyoto Protocol. In the meantime, the Australian Government is seeking to expand the types of eligible activities under the Kyoto Protocol, to include soil carbon and deforestation, as part of its international negotiations for the post-2012 regime.¹²⁹

The CDM mechanism under the Kyoto Protocol was one of the first examples of an international market-based offset mechanism designed to contribute to global efforts to reduce atmospheric concentrations of

¹²³ *Clean Energy (Unit Shortfall Charge—General) Act 2011* (Cth), s 8.

¹²⁴ Unless a lesser rate is prescribed by the regulations, *Clean Energy (Unit Shortfall Charge—General) Act 2011* (Cth), section 8.

¹²⁵ UNFCCC, "Outcome of the Work of the Ad Hoc Working Group on Long-Term Cooperative Action under the Convention" (COP 17; December 2011; advance unedited version), E [79].

¹²⁶ CFI Act, Part 3, Division 12.

¹²⁷ *Carbon Farming Initiative: Offset Methodologies*, Australian Government, Department of Climate Change and Energy Efficiency, available at <<http://www.climatechange.gov.au/government/initiatives/carbon-farming-initiative/methodology-development/methodologies-under-consideration.aspx>> viewed 10 January 2012.

¹²⁸ A native forest is defined to exclude plantations. However, the definition notes that "it is immaterial whether any of the trees have been established with human assistance following flood; bushfire; drought; pest attack; or disease", CFI Act, s 5.

¹²⁹ Significant progress was made on the inclusion of deforestation at COP 17 in December 2011. See UNFCCC, "Outcome of the Work of the Ad Hoc Working Group on Long-Term Cooperative Action under the Convention" (COP 17; December 2011; advance unedited version), C; and UNFCCC, "Land Use, Land-Use Change and Forestry" (CMP 7; December 2011; advance unedited version).

greenhouse gases. The CDM is by no means a perfect mechanism and the test of additionality under the CDM, in particular, has been criticized for being both overly complex and inherently subjective.¹³⁰ This has led to higher transaction costs in the carrying out of CDM projects.¹³¹ These concerns regarding the weaknesses of the CDM appear to have influenced the Government in its design of the Carbon Farming Initiative. In contrast to the CDM, under the Carbon Farming Initiative activities are *deemed* to have met the additionality test where they are contained on the “positive list” in the regulations and are not in response to a requirement under any law of the Commonwealth, State, or Territory.¹³²

In considering activities for inclusion on the positive list, the Minister was required to have regard to the advice of the Domestic Offsets Integrity Committee and to consider whether the carrying out of the project is “not common practice” in the relevant industry or environment.¹³³ Financial additionality was not required to be demonstrated. Baseline setting was also simplified and this is stated simply as being calculated on the assumption that the project is not carried out.¹³⁴ While these modifications have come from a desire to reduce transaction costs, the lack of compatibility with the rules of the CDM will have consequences in terms of the ability to surrender Carbon Farming Initiative credits as eligible offsets under the post-2012 Kyoto Protocol regime and other linked international carbon markets.

Additional activities included on the “positive list” currently include:

- The establishment of permanent plantings on or after 1 July 2007;
- The human-induced regeneration, on or after 1 July 2007, of native vegetation, on land that is not conservation land, by:
 - (i) the exclusion of livestock; or
 - (ii) the management of the timing and the extent of grazing; or
 - (iii) the management, in a humane manner, of feral animals; or
 - (iv) the management of plants that are not native to the project area; or
 - (v) the cessation of mechanical or chemical destruction, or suppression, of regrowth;
- The application of biochar to soil;
- The capture and combustion of methane from livestock manure;
- Early dry season burning of savanna areas greater than 1 km²;
- The reduction of methane emissions through the humane management of feral goats, feral deer, feral pigs or feral camels;
- The reduction of emissions from ruminants by manipulation of their digestive processes;
- The application of urease or nitrification inhibitors to, or with, livestock manure or fertiliser; and
- The capture and combustion of methane from waste deposited in a landfill facility before 1 July 2012.¹³⁵

Permanence is a significant issue in the design of the Carbon farming Initiative. Sequestered carbon can be released to the atmosphere as a result of land clearing, timber harvesting, bushfires, disease and decay of the trees. Because of this, the Kyoto Protocol CDM created only temporary credits for afforestation and reforestation projects under the first commitment period. However, this approach has not been adhered to

¹³⁰ See Durrant Nicola, *Legal Responses to Climate Change*, (Federation Press, 2010) p 61.

¹³¹ Garnaut Review, n36, p182.

¹³² CFI Act, s 41.

¹³³ CFI Act, Part 9, Division 3.

¹³⁴ CFI Act, s 107.

¹³⁵ *Carbon Credits (Carbon Farming Initiative) Regulations 2011* (Cth), 3.28.

in the domestic context and the Carbon Farming Initiative will issue permanent carbon credits for these temporary abatement activities.¹³⁶

Under the Carbon Farming Initiative, forest operators are only held liable for any net losses in carbon stocks for a maximum 100 year period and there are mechanisms in place for the removal of that obligation upon payment of financial penalty.¹³⁷ There is no mechanism in place under the scheme for the cancellation of these permanent credits following the loss of carbon stocks from which they originated.

During the fixed charge period, liable entities will be permitted to surrender up to 5 per cent of eligible credits from the Carbon Farming Initiative to satisfy their liabilities under the Carbon Pricing Mechanism. Once the flexible charge period commences, there will be no restrictions on the number of eligible credits able to be surrendered from the Carbon Farming Initiative. This will have the effect of increasing the allocated “market cap” under the Carbon Pricing Mechanism by an undetermined amount, undermining the price signal.

The use of these permanent credits from temporary emission reductions has significant repercussions for the credibility of the Carbon Pricing Mechanism. These credits can be purchased, held and surrendered by Australian entities - purporting to represent a permanent emissions abatement that no longer exists. These credits can also be traded to other parties to the Kyoto Protocol on the international market as well as into other international and regional trading systems. This could have very negative implications for both the economic value of Australia’s credits in those markets as well as the overall effectiveness of both the Australian and international schemes in reducing greenhouse gas emissions. As rightly noted by Garnaut, “linking with an economy that has a flawed domestic mitigation system will result in the import of those flaws.”¹³⁸

10. Linkages with the International Kyoto Protocol Carbon Market

In order for Australia to be eligible to trade on the Kyoto Protocol Market it must have complied with the eligibility requirements for participation. These include requirements to have in place a national system for the estimation of emissions; to submit annual estimates of emissions and, importantly, to maintain a specified level of reserve emissions instruments within the party’s national registry as follows:

each Party included in Annex I shall maintain, in its national registry, a commitment period reserve which should not drop below 90 per cent of the Party’s assigned amount calculated pursuant to Article 3, paragraphs 7 and 8, of the Kyoto Protocol, or 100 per cent of five times its most recently reviewed inventory, whichever is lowest.¹³⁹

Australia has established an electronic national registry, known as the Australian National Registry of Emissions Units, as required by the Kyoto Protocol and this holds Australia’s allocation of AAUs for the first commitment period under the Kyoto Protocol.¹⁴⁰

¹³⁶ CFI Act, Part 11, Division 2. A risk reversal buffer of 5 per cent will be subtracted from the total calculated net abatement/sequestration number for the project to protect against the risk of loss of stocks from natural disturbances.

¹³⁷ CFI Act, Part 8.

¹³⁸ Garnaut Review, n36, p 337.

¹³⁹ UNFCCC ‘Decision 11/CMP 1: Modalities, Rules and Guidelines for Emissions Trading under Article 17 of the Kyoto Protocol, Annex: Modalities, Rules and Guidelines for Emissions Trading under Article 17 of the Kyoto Protocol’, (FCCC/KP/CMP/2005/8/Add 2) at [6]-[11].

¹⁴⁰ This includes the 2,957,579,143 AAUs received from the UNFCCC Secretariat on 14 July 2009, Australian Government, “Australian National Registry of Emissions Units” (Department of Climate Change and Energy Efficiency, 2011) < <http://www.climatechange.gov.au/Home/government/initiatives/anreu.aspx> > viewed 10 January 2012.

The Kyoto Protocol permits trade on the international market by private entities where they are authorised to trade on behalf of a State and Australia has indicated that it will extend that authorisation to private entities.¹⁴¹ During the fixed charge period, international emissions units will not be able to be surrendered in compliance with the Carbon Pricing Mechanism.¹⁴² However, during the flexible price period eligible international units may be acquired and surrendered in compliance with the Carbon Pricing Mechanism.¹⁴³ Eligible international units currently include the following units issued under the Kyoto Protocol: CERs (other than a long-term or temporary CERs issued in relation to CDM forestry projects); ERUs generated by JI projects and removal units (RMUs).¹⁴⁴ AAUs are not able to be surrendered in compliance with the Carbon Pricing Mechanism. The Government has also indicated that future restrictions will be imposed on the types of eligible international units.¹⁴⁵

Despite the involvement of private players with Australia, the Government will remain ultimately responsible for compliance with its obligations and with the pre-requisites for eligibility to trade under the Kyoto Protocol.¹⁴⁶ The UNFCCC Secretariat monitors all sales and purchases of permits through an International Transaction Log (ITL). For each proposed private or public transaction of allowances between registries, the ITL automatically verifies the validity of the transaction, including for example, whether both States are eligible to trade.¹⁴⁷ In the event of an identified discrepancy the transaction will be cancelled and any resulting losses to transacting parties (be they public or private) will lie where they fall.¹⁴⁸

11. Future Linkages with Overseas Carbon Trading Schemes

An efficient carbon trading system requires a large number of players and volume of trades in order to reduce mitigation costs and price volatility.¹⁴⁹ Accordingly, the Government should be seeking to establish a trading system that is able to link with other existing domestic and regional carbon trading markets.¹⁵⁰ The Government intends to establish bilateral links with those schemes that are considered to be of a suitable standard, based on a range of criteria including:

- an internationally acceptable (or, where applicable, a mutually acceptable) level of mitigation commitment;
- adequate and comparable monitoring, reporting, verification, compliance and enforcement mechanisms; and
- compatibility in design and market rules.¹⁵¹

The Government is particularly interested in establishing future linkages with the European Union and New Zealand trading schemes and commenced discussions at the international climate change

¹⁴¹ Ibid.

¹⁴² Clean Energy Commentary, n30, p 92.

¹⁴³ Clean Energy Commentary, n30, p 33

¹⁴⁴ *Australian National Registry of Emissions Units Act 2011*(Cth), s 4.

¹⁴⁵ Including restrictions on removal units (RMUs) issued on the basis of land use, land-use change and forestry activities under Article 3.3 or 3.4 of the Kyoto Protocol and CERs or ERUs from nuclear projects, the destruction of trifluoromethane, the destruction of nitrous oxide from adipic acid plants or from large-scale hydro-electric projects not consistent with criteria adopted by the EU (based on the World Commission on Dams guidelines). See Clean Energy Commentary, n30, p 93.

¹⁴⁶ UNFCCC 'Decision 11/CMP.1: Modalities, Rules and Guidelines for Emissions Trading under Article 17 of the Kyoto Protocol, Annex: Modalities, Rules and Guidelines for Emissions Trading under Article 17 of the Kyoto Protocol', (FCCC/KP/CMP/2005/8/Add 2), [5].

¹⁴⁷ UNFCCC, Decision 13/CMP.1, n 20, D [38].

¹⁴⁸ UNFCCC, Decision 13/CMP.1, n 20, D [43].

¹⁴⁹ Garnaut Review, n36, p 338.

¹⁵⁰ Garnaut Review, n36, p 337.

¹⁵¹ Clean Energy Plan, n6, p 108.

negotiations in Durban. Consistency between the schemes would be a critical prerequisite to a positive linkage. These linkages should only occur if Australia has designed its scheme with all the necessary legal features and in a manner compatible with the key legal features of those other trading schemes. In short, this is an area where it does *not* pay for the Australian Government to be too clever, or too creative, in establishing a very different creature of trading system. This includes consistency in coverage of sectors and inclusion of greenhouse gases, in approaches to the recognition of eligible offsetting activities, in the use of price ceilings and price floors and in the monitoring and verification methodologies. However, in all of these aspects, the design features of the Australian scheme do not conform to the features of the European Union and New Zealand trading schemes.

12. The Future of Australia's Carbon Pricing Mechanism?

While the passage of legislation to establish an emissions trading system is a very positive step for Australia, this analysis has identified a number of aspects of concern in the design of the Australian Carbon Pricing Mechanism. It is possible that these issues, either alone or in combination, will act to undermine the effectiveness of the Australian scheme both in terms of the price signal that is sent to emitters and in terms of the credibility of the scheme in achieving actual reductions in Australia's greenhouse gas emissions. In the meantime, one of the most critical prerequisites for an effective carbon trading system, that is clarity and predictability about the future rules and shape of the trading scheme, remains stubbornly elusive.¹⁵² Given Australia's current political climate, it is quite possible that the Government will be displaced at the coming elections in late 2013. The leader of the opposing Coalition party has vowed to repeal the "Carbon Tax" as soon as his party gains power and has made it clear that compensation will not be payable to those affected by the repeal of the trading scheme.¹⁵³ Opinion is divided on whether this is politically, financially or legally feasible. The Government has deliberately designed the scheme so that the complex financial assistance mechanisms, tax reforms, subsidies, levies, free allocations and auctioning of units will all be deeply embedded at the time of the next election. If the Coalition party does not win a majority in the House of Representatives or Senate then it would need the support of other members of Parliament, including those Labor, Greens and Independent MPs who have designed the trading scheme and have made it clear that they will not lend their support to its repeal.¹⁵⁴ The only alternative would be for the Government to trigger the double dissolution provisions under the Australian Constitution leading to a double dissolution election and subsequent joint sitting of both Houses of Parliament.¹⁵⁵ This would be likely to provide the Government with sufficient numbers to pass the legislation to repeal the scheme.¹⁵⁶

If the legislation is repealed, then the question remains whether compensation will be payable for the carbon permits rendered "useless" by the repeal of the trading scheme. The Clean Energy Act notes that these permits are "personal property" and that compensation on "just terms" would apply if the operation of the Act or regulations resulted in the acquisition of property.¹⁵⁷ However, this in itself does not mean that these units are truly "personal property" nor that compensation will be payable in these circumstances. Complications have emerged in the context of tradable water entitlements where the High Court of Australia has held that reductions in the water allocations of members of the agricultural industry did not amount to an acquisition of property as the tradeable licences were no more than a "species of property" granting an entitlement to access a common resource; *and* it was not an acquisition as there was

¹⁵² Stern N, 'The Economics of Climate Change: The Stern Review' (Cabinet Office, HM Treasury 2006), p xviii.

¹⁵³ Hunt Greg, "How to Repeal the Carbon Tax" (The Australian, 25 October 2011).

¹⁵⁴ Note: only half the positions in the Senate will be included in the 2013 election. Kirk Alexandra "Opposition 'dreaming' on carbon tax repeal: Combet" (PM with Mark Colvin, 17 October 2011) <<http://www.abc.net.au/pm/content/2011/s3341652.htm>> viewed 10 January 2012.

¹⁵⁵ The legislation would have to be twice passed by the House of Representatives and twice rejected by the Senate leading to the call of an early election under section 57 of the Australian Commonwealth Constitution.

¹⁵⁶ Hunt, n153.

¹⁵⁷ Clean Energy Act, s 308.

no benefit or advantage to the State from limiting access to that common resource.¹⁵⁸ Whether compensation will be payable for the cancellation of the carbon permits will therefore depend on whether the High Court of Australia characterises these permits as personal property *and* determines that the outright repeal of the scheme (rather than the direct cancellation or acquisition of permits) is sufficient to trigger the compensation requirements under the Australian Constitution. In the meantime, Australian businesses are faced with a dilemma of whether to embrace the new carbon price, and begin making the necessary business planning and investment decisions, or assume that it will be merely a temporary legal measure.

¹⁵⁸ *ICM Agriculture Pty Ltd v the Commonwealth* [2009] HCA 51.