



Carbon Pollution Reduction Scheme

Summary analysis of the Australian Government's Green Paper

July 2008

AUSTRALIA



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Introduction

KPMG welcomes the release of the Carbon Pollution Reduction Scheme Green Paper (Green Paper) as the first comprehensive step in the process to designing and implementing an Australian emissions trading scheme.

The Green Paper is a detailed policy position of the Australian Government and puts forward a position to overcome most hurdles highlighted in the public debate over the last 12 months. It provides a level of detail that constructs a rich, in-depth and complex basis for discussion with industry and the broader community. At the same time there are some gaps and issues that need to be resolved, and it will be important for industry to actively engage in the debate over the coming months. For example, limited information is provided with regard to caps, secondary market trading in permits and prevention of anti-competitive behaviour, which will need to be addressed in time for the efficient operation of the Carbon Pollution Reduction Scheme (the scheme).

It is noted that the Government intends to bring about major economic change in a measured manner in order to allow businesses and the wider community time to adapt. It is important, therefore, for businesses to take advantage of the opportunity to plan for the transformation and not necessarily delay action.

The proposed scheme is an essential platform in the Government's policy to reduce carbon emissions. The cap and trade design of the scheme allows the Government to set the volume of carbon emissions allowed within the economy (the cap) and relies on the market to determine the price of permits by trading of permits in the market (the trade), or taking action to reduce emissions, where this provides a cheaper alternative.

The design features of the scheme are central to its effectiveness in achieving the goals of reducing carbon emissions and the impacts of climate change at least cost to the economy and the community.

KPMG encourages businesses to assess the strategic risks and opportunities that arise from the Government's suggested architecture for the scheme, and to become involved in providing submissions on the Green Paper to the Government, by the closing date of 10 September 2008. Business leaders are interested in gaining greater insight into the areas of the Green Paper that have the highest potential impact on their operations. These include:

- sector and GHG coverage under the Carbon Pollution Reduction Scheme and transitional issues
- emission trajectories for emission pollution permits
- price cap of emission pollution permits
- primary market architecture and governance
- linkages with international schemes
- treatment of Emissions-Intensive Trade-Exposed Industries (EITEs)
- treatment of Strongly Affected Industries (SAIs)
- tax and accounting related issues
- transition issues for existing state-based schemes.

Purpose of KPMG's summary analysis

The purpose of KPMG's summary analysis is to provide clarity surrounding these elements by providing a brief overview of the Government's position. This will assist businesses in assessing potential scenarios surrounding the impacts of the key elements. The structure of this summary reflects:

- a snapshot of the Green Paper
- an outline of suggestions for businesses to identify their involvement in the scheme (coverage) and likely impacts on their industry
- a detailed synopsis of the Green Paper framework
- issues needing consideration
- the tax and accounting issues in relation to the proposed design of the scheme.

Summary on the Government's proposed scheme

- The Government is proposing to introduce the scheme in 2010.
- Coverage is broadly based both in terms of greenhouse gases (all six Kyoto gases are covered) and economic sectors. Sectors included are:
 - stationary energy
 - industrial processes
 - fugitive emissions
 - waste
 - transport (excluding international transport)
 - forestry on an opt-in basis
 - possible inclusion of agriculture in 2015 to be decided in 2013.
- The scheme sets the obligation to surrender permits at an emission threshold for facilities of 25kt/annum of CO₂-e.
- Petrol will be included in the scheme and households will be assisted with the price increase through the Government reducing the fuel tax on a cent-for-cent basis to reduce the price impact of the scheme.
- An annual emissions cap will be set on a rolling five year basis with a gateway set for the following 10 year period. The level of the annual cap for the first three years should be announced this year with the next two years and the 10 year gateway determined prior to the start of the scheme in 2010.
- A range of assistance mechanisms for industries most impacted by the scheme will be granted in certain circumstances including the following:
 - Activities with an emissions intensity above 2kt CO₂-e/\$ million revenue will at first receive free permits that cover approximately 90 percent per unit of output.
 - Activities with an emissions intensity of 1.5kt CO₂-e / \$ million revenue will at first receive free permits that cover approximately 60 percent per unit of output.

The assistance for these sectors - the EITE's (including agriculture once it is covered) - in the form of free permits will use approximately 30 percent of the available permits.

- SAIs will also be assisted. This includes coal fired electricity generators which will receive assistance through the Electricity Sector Adjustment Scheme on an asset by asset basis in proportion to their capacity. Total available assistance will be divided between brown and black coal fired power plants. This assistance will be granted on a 'once and for all basis'.
- A Climate Change Action Fund will be established to assist businesses adjust to a low carbon economy by funding investment in innovation in low carbon technology, development of industrial energy efficiency, and education and awareness for small to medium size businesses.
- Australian emissions units will be auctioned on a quarterly basis by the regulator established under legislation, whose role among other things is to manage the auctions.

- Unlimited banking of Australian emissions units will be permitted, however a percentage limit (5 percent is proposed) will apply on the amount of units an entity may borrow from future years' caps.
- A cap on the permit price for the period 2010-15 set higher than the expected market level to reduce the risk to economy in the transition.
- Design of the scheme is intended to be compatible with international schemes for eventual linkages with other carbon trading markets. However, there will be a limit on the volume of international emissions permits allowed for compliance with the domestic scheme in the initial years.
- An operating cycle that is based on a financial year aligning with the National Greenhouse and Energy Reporting (the NGER Act) regulation.
- Independent third party assurance likely to be required for large emitters >125kt CO₂-e. The level of assurance required for statutory financial reporting will set the minimum required assurance levels for all parties.
- Accounting guidance to be determined by national and international standard setters.

Snapshot of implications for business and industry

The following table is KPMG's initial assessment of issues that business and industry need to consider and possible actions that they need to be taking now.

Issues to consider	Business implications	What you can do today?
Uncertainty regarding trajectories, cap and pricing.	Risk of uncertainty reduces ability to mobilise mitigation responses to additional costs.	Scenario modelling to provide direction on cost implications and assist with contingency planning, investment and hedging requirements.
Unknown manner in which the fuel provision will be reviewed after three years.	Businesses with large fleets or logistics companies may need to adjust budgeting and liability.	Engage with the consultation process and seek greater certainty and transparency in the policy.
The penalties regarding covered industries not fully meeting their obligations in the scheme is not clarified.	Actions could include statutory enforcement of fines and civil and criminal penalties.	Get involved in the debate to ensure that the penalties are proportionate to the impact of non-compliance.
Financial statement audit requirements may require entities not covered by the Green Paper discussion regarding mandatory assurance, to also obtain assurance where there is a material impact on the financial statements.	Entities required to engage an auditor, should monitor assurance developments. Moreover, entities not included in the mandatory requirements, should monitor the need to have emissions audited in support of the balances arising in the financial statements.	Focus on developing emissions reporting systems, processes and controls to ensure you are well placed to meet assurance requirements.

Timeline and next steps

10 September 2008	Submissions on Green Paper by industry and community.
By December 2008	Government to release the White Paper.
Early 2009	Introduction of the Carbon Pollution Reduction Scheme legislation into Parliament.
Mid 2009	Achievement of passage of the Bill.
Mid – late 2009	Consultation on the regulations.
Late 2009	The Act comes into force.
2010	Carbon Pollution Reduction Scheme commences.
2013	Assessment of inclusion of Agriculture into the scheme.
2015	Clarity on coverage of Agriculture into the scheme.

Policy context

The Federal election of 2007 resulted in a change of government that has seen an expedited approach to addressing reductions in GHG emissions. The Green Paper is an initial government proposal and it represents the first major step in outlining possible broad options for the design and implementation of an emissions trading scheme. It is intended to be broad in nature and invites industry and the wider community to provide input into detailed elements of the design.

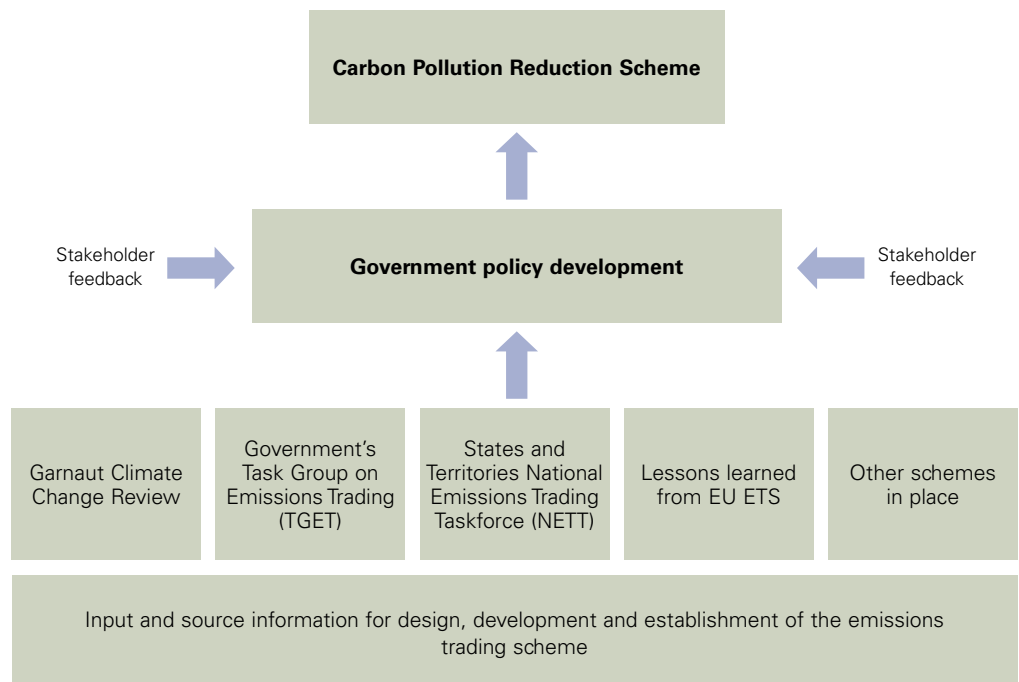
The Government's policy agenda

The Government and the community view climate change to be one of the greatest social, economic and environmental challenges of our time. It accepts the expert scientific evidence that human activity is altering the climate with detrimental socio-economic effects for Australia. The Government is committed to ensuring Australia meets its responsibilities in facing the global challenge of climate change and has a comprehensive approach for achieving this objective which includes:

- reducing emissions in the short and long term
- working with the international community to develop an equitable and effective global response
- preparing for the inevitable impacts through a National Climate Change Adaptation Plan.

Inputs into the design of the scheme

The following diagram illustrates the steps and key inputs into the Government's development of the scheme.



Government objectives

The Government has adopted a plan of domestic action to achieve its outcomes with the following key elements.

A commitment to reduce Australia's GHG emissions by 60 percent on 2000 levels by 2050

The mechanisms by which to achieve this objective are:

- commissioning a major study on reducing emissions, which has resulted in the Garnaut Climate Change Review (a draft was released on 4 July 2008)
- modelling and analysing the science, impacts and socio-economics associated with emissions reduction to determine short and medium term targets to achieve the 2050 commitment in a manner that continues the prosperity of all Australians
- implementing a comprehensive emissions trading scheme by 2010 to deliver these targets and a market mechanism that provides incentives to reduce GHG emissions in a cost-effective way.

Setting a 20 percent target for renewable energy by 2020 to dramatically expand the use of renewable energy

Investing in research and development on low emissions technologies

This will be achieved through investment in clean fossil fuels, biofuels, hydrogen and energy efficiency technology through incentive packages, tax rebates or government grants to stimulate the development of such products and services.

Helping households and business to use energy more wisely

This will be achieved through direct financial incentives and stronger energy efficiency regulations that are target driven and education and awareness.

Managing our land to reduce emissions

This will be achieved through participatory programs with farmers to encourage more sustainable farming practices that reduce emissions and create carbon sinks.

Global cooperation

The Government accepts climate change as a global problem requiring global action and solution. As such, a range of international cooperation and multilateralism has formed part of the Government's means of addressing the challenges of climate change.

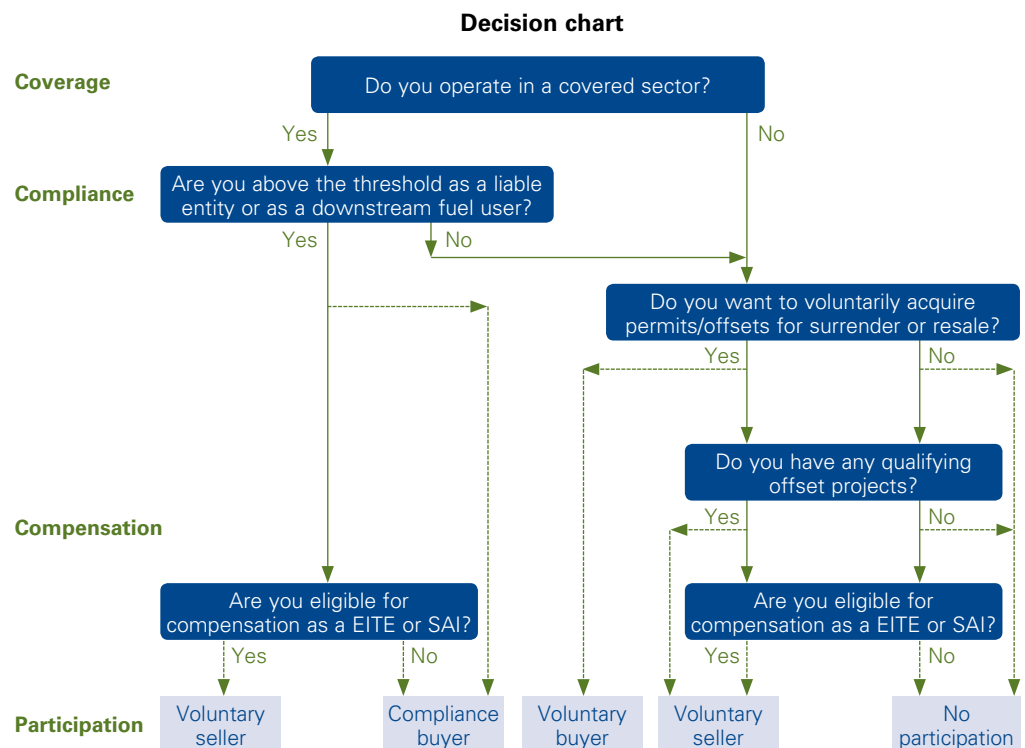
The first official act of the new Government was the ratification of the Kyoto Protocol, committing Australia to ensure GHG emissions over 2008-12 are no more than 8 percent above 1990 levels.

Are you covered?

The Government is recommending broad sector coverage amounting to 75 percent of Australia's emissions including approximately 1000 entities. The purpose of broad coverage is:

- to minimise the overall cost of emissions to the Australian economy
- achieve carbon emissions reductions equitably across the economy
- ensure competing businesses and sectors operate within equivalent market rules.

The following decision tree may assist you to ascertain your possible role within the scheme as suggested by the Green Paper.



Gases

The Government is recommending that the six GHGs included under the Kyoto Protocol are covered by the domestic scheme from commencement. Both direct and indirect emissions are included.

Points of obligation

Points of obligation are points in the supply chain where scheme obligations are applied. The Green Paper suggests two possible points of obligation that are dependent on the operations or composition of the industry of the covered entity.

- Direct obligation: at the point of physical production of emissions.
- Indirect obligation: applied at a point within the supply chain.

Thresholds

The Government is recommending that thresholds for the scheme reflect and are in line with those advocated by the NGER Act. The direct obligation would be for facilities emitting a minimum of 25kt CO₂-e/annum.

Covered sectors

Stationary energy

Stationary energy is currently the largest contributor of GHG (approximately 50 percent) and the fastest growing source of emissions. Coverage in the scheme is likely to be determined through the application of points of obligation and thresholds. It includes:

- electricity generation
- petroleum refining
- manufacturing and construction industries
- home heating (point of obligation at the fuel supplier)
- on-site diesel generation (point of obligation at the fuel supplier)
- on-farm machinery (point of obligation at the fuel supplier).

Transport

Accounts for 14 percent of Australia's emissions, of which 90 percent is road transport. Comprehensive and cost-effective coverage of emissions in this sector is best achieved by applying the point of obligation at the upstream fuel supplier.

The fuel types included in transport are vast, and the point of obligation within the supply chain is expected to vary according to different fuel types.

Liquid and gaseous fuels include:

- petroleum
- diesel
- LPG
- LNG (obligation at producer)
- CNG (obligation at producer)
- natural gas
- 'anything to liquids'.

Petroleum products are primarily used in the transport sector, the stationary energy sector and the industrial process sector. There are a number of different groups of each petroleum product and each has a different supply network and is treated uniquely with regard to obligation. The groups included in this sector include:

- standard petroleum fuel products (petrol, kerosene, fuel and diesel oil)
- non-standard petroleum products (lubricants, bitumen, petroleum coke, waxes, waste lubricating oil)
- biofuels (bioethanol or ethanol and biodiesel).

The Green Paper suggests three options with regard to points of obligation in this sector with the preferred position being for the obligations for emissions from fuel burning be applied to all fuel excise and custom duty remitters for all liquid fuels currently subject to fuel excise and excise-equivalent customs duty. In this way comprehensive coverage is attained and well-tested administrative systems already exist.

Fugitive emissions

Fugitive emissions released during the following operations will be covered:

- extraction of oil and gas
- oil and gas processing
- leaks from gas pipelines
- waste methane from black coal mining
- facilities (emitting more than 25kt CO₂-e/annum) including some coal mines (open cut and underground).

The Green Paper suggests applying the obligation to such fugitive emissions producing facilities with direct emissions of 25kt CO₂-e/annum or more. However, more clarity will be required to understand the relationship between boundaries of emissions and ownership of permits.

Industrial processes

The largest single source of emissions in this sector are from the manufacturing of iron, steel, cement, lime and aluminium through chemical reactions other than the combustion of fuel. The Government suggests inclusion by applying the obligation to facilities with direct emissions of 25kt CO₂-e/annum or more. However, in the case of synthetic GHG emissions the point of obligation will be for bulk importers of these gases, and importers of the equipment containing such gases. The determining threshold is yet to be disclosed.

Waste

The Green Paper suggests the Government's preferred position is for inclusion of waste in the scheme, however, details regarding the scope, thresholds and other issues are not discussed. Included in this sector are:

- solid waste to landfill
- wastewater
- solvent and clinical waste incineration.

Forestry

The Forestry sector has been included on an opt-in basis implying that participation is voluntary. Forestry landholders who opt-in/participate in the scheme, will be issued carbon pollution permits additional to the cap for the increased net quantity of CO₂-e stored in the forest. Those landholders opting in would incur a liability that is imposed for net reductions in CO₂-e. The intention is to include forests planted prior to 1990 unlike the Kyoto Protocol Accounts.

The opt-in provisions allow for flexibility regarding potential shifts in land use and other interactions with water markets (i.e. through the National Water Initiative) and biodiversity. It also provides a powerful incentive for the planting of carbon sinks that are not intended to be cut down.

It is not proposed to include deforestation within the scheme as Australian deforestation emissions have reduced markedly since 1990 as a result of protections against land clearing.

Agriculture

Intended to be included from 2015 but the final decision will not be made until 2013.

Offsets

Domestic-based offsets

The preferred position is that offsets will only be considered in situations where it is not possible to cover the relevant sector in the scheme and cost effectively mitigate emissions by the use of other policy tools, such as regulation or tax. The agriculture sector is not covered by the current scheme proposal so could be considered as a possible source of offset credits. However, it is a preferred option that it be included in 2015 thus making it unlikely that offsets project could be implemented before coverage is enacted. The key criteria for the acceptance of any offset scheme is that it must be additional to what would have happened had it not been implemented. The issue of including offsets will be reviewed in 2013.

International-based offsets

The preferred option is to allow the limited use of the three types of Kyoto offset credits; those generated by Clean Development Mechanism (CDM), by Joint Implementation (JI) and from Land Use, Land Use Change and Forestry (LULUCF) projects. Non-Kyoto credits will not be accepted.

Carbon Capture and Storage

The Government's preferred position on the treatment of Carbon Capture and Storage (CCS) is as a carbon emission reducing activity resulting in emitters able to net out those emission captured. However, fugitive emissions through transporting carbon to the storage facility would be imposed on the operator of the CCS facility. The proposal by the Government to include CCS as a reduction mechanism is a firm acknowledgement that technology of this nature is imperative to achieve carbon reduction at least cost to the economy. It provides a clear price signal to investment in this type of technology.

How will permits be allocated?

The Green Paper indicates that there will primarily be three separate ways – via auction, via free allocation to EITEs and SAIs only, and via offset arrangements. As discussed elsewhere, it is expected that there will be limits on the proportion of total permits that will be allocated free. This limit and correspondingly the number of permits that are available for allocation via an auction process and through offset arrangements (the proportion of which is also to be limited at least in the early years) will be a function of the overall cap on emission levels, and this has not yet been decided.

The discussion in this section focuses on what the Green Paper has indicated in relation to the:

- use of an auction mechanism to allocate permits
- development of a carbon market to provide price signals about the costs of emission reduction activities.

The majority of permits within the scheme will be auctioned and the Green Paper indicates that over the longer term there will progressively be a move towards 100 percent auctioning. Auctions are supported as an allocative instrument because they have excellent efficiency properties and will support the process of price discovery around the costs of undertaking actions to reduce emission levels.

In terms of the governance around the auction process (i.e. setting and revising auction rules, holding auction events), this role is expected to be fulfilled by the Regulator of the scheme. However, given the 2010 start date the relevant Minister is expected to make initial decisions on the auction framework and corresponding auction rules so that business has a degree of certainty about the design of the auction framework before the first auctions are held. The responsibilities of the scheme regulator, the design of the auction framework and the relevant Minister's power of direction will be reviewed after 5 years of the scheme's operation.

The preferred positions in relation to key auction design parameters are outlined below.

- Auction structure – the Green Paper identifies an ascending auction as the preferred structure for allocating emission permits. This structure is similar to the way in which houses are typically auctioned, as participants will bid prices up from their opening level once the auction commences. Consideration is being given to allowing entities who have received free allocations of emission permits on the basis of being trade-exposed or heavily affected to sell permits they do not require in these auctions, in conjunction with the Government.
- Auction frequency – the preferred position is that four auctions will be held each financial year, one in each quarter. Permits from several years may be auctioned at any given event.
- Auction start date – it is expected that some permits will be auctioned in advance of the start of the scheme to provide early carbon price signals to businesses. However, practical considerations such as the need to establish a registry for emission permits and the Regulator's institutional arrangements act to limit how early the first auction can occur. First auctions under the scheme are likely to occur early in 2010.
- Auctioning of future vintages – the preferred position is for the auction events to include permits associated with the current year and a number of permits for the subsequent four years. This will support the emergence of price signals about the costs of reducing carbon emissions.
- Auction participation – in order to support competitive pressures within the market and the overall efficiency of the scheme, it is expected that universal participation will be permitted provided any required security deposits have been lodged.
- Pricing rule – it is expected that a uniform pricing rule will apply whereby the same price is paid by all successful participants in a given auction event.

- Reserve prices – it is expected that permits in the auction will have a reserve price, which will be the minimum price below which bids are not accepted. Any permits not allocated at a given auction event will be sold at a future auction event.
- Parcel sizes – the maximum number of permits (i.e. parcel size) which a single participant can acquire at a given auction event may be limited to ensure credible auction results while still allowing legitimate bidders to participate at auction.

In relation to the development of a carbon market in Australia, the Green Paper points to the critical importance of a credible scheme for carbon pollution (or emission) permits and associated financial markets for these permits in pursuing the scheme's overarching environmental and economic objectives, particularly investment in abatement and low-emission technologies.

When a credible market for emission permits is established in Australia, an effective and sufficiently liquid financial market should emerge with price discovery in forward markets – aided by the auction framework discussed above – providing the necessary signals for efficient and timely investment.

Market architecture

The Green Paper provides some limited insight into the proposed design features of the market. These include:

- a cap on the number of carbon polluting permits is to be issued and this will be the basis for the national emission trajectory over the following 5 years (i.e. from 2010 to 2015)
- as there will be no barriers as to who can purchase or hold permits, the carbon market will benefit from the complete transferability of emission permits
- the ability for unlimited banking of emission permits will also support development of the carbon market by ensuring a long-term commitment to the scheme
- the proposal for a limited degree of emission permit borrowing from future years (less than 5 percent) will also support development of the carbon market by providing participants with increased flexibility around how they manage their emission liabilities
- there will be a cap on the maximum price of carbon pollution permits from the period 2010-15 that is likely to be well above the estimated market price of permits.

What assistance is available?

Strongly affected industries

The Green Paper indicates that a limited amount of assistance will be provided to industries that are strongly affected by the commencement of the scheme.

The industry which is expected to be affected most significantly by the commencement of the scheme is the coal fired electricity generation industry. The Green Paper states that the basis for this view is the observations that coal fired electricity generators are:

- highly emissions intensive
- unable to fully pass on their carbon costs
- the owners of significant long-lived assets with limited alternative uses
- able to access few, if any, financially viable abatement options (i.e. carbon capture technologies are yet to be commercially proven).

However, the Green Paper also indicates that assistance to coal fired electricity generators is not based solely on the fact that these entities will be strongly affected by the commencement of the scheme. Broader economic factors have influenced the Government's position, including the need to avoid perceptions of unanticipated regulatory risk within the investment community and the need to provide certainty for future investments in the electricity generation sector.

Assistance to the electricity sector is to be delivered, in part, through a new mechanism called the Electricity Sector Adjustment Scheme. This mechanism is intended to complement existing government programs such as the National Clean Coal Initiative and over time facilitate structural adjustment in the industry whilst also ensuring the security of energy supplies. The nature of any assistance provided to a given generator will have regard to their level of capacity and whether they use brown coal or black coal in their generation activities.

The ultimate level and form of assistance to the electricity generation sector is to be finalised following consultation with the industry – this assistance may include the provision of free emission permits. The Green Paper notes that the Government's preferred position is that any assistance to the electricity generation sector will be provided on a 'once and for all' basis and further allocations of assistance will not be provided. Particular care will be taken to ensure that any assistance provided does not deliver windfall gains to the generation sector.

Accounting implications

The Green Paper raises the possibility of attaching conditions to any assistance provided to SAIs (either via free allocation of permits or cash). Under current accounting standards, any conditions attached may delay the recognition of this assistance in the income statement and/or balance sheet until the conditions are complied with.

The provision of assistance to SAIs may, to some extent, mitigate potential impairment issues due to its positive effect on discounted cash flow (DCF) calculations.

Assistance to Emissions-Intensive Trade-Exposed industries

The Green Paper confirms that once the scheme commences, assistance will be provided to EITEs in Australia so they do not incur a competitive disadvantage when participating in the global market. In the absence of any such assistance, there is a risk that Australian businesses may relocate to countries that do not have carbon reduction schemes, with there being no consequent reduction in overall emission levels (referred to as carbon leakage).

Within the Green Paper a number of specific proposals for this assistance are put forward – generally though, this assistance is intended to offset material emission liabilities associated with the proportion of any given EITE business output that is sold into the global market.

The Green Paper indicates that assistance will be based upon a measure of the emissions intensity per unit of revenue (for a given firm) rather than one based on emissions per unit of value add in the interests of transparency and enabling comparisons between eligible businesses.

The Green Paper indicates that the proposed form of assistance is an allocation of free emission permits. However, the Green Paper also signals that there will be two different tiers of assistance depending on the level of emissions intensity amongst EITEs – significant or moderate. Furthermore, it is also signalled that assistance will be based upon emissions intensive activities that lead to the production of trade-exposed products, rather than on the basis of a firm or industry level.

Within the Green Paper the Government proposes that:

- a significant level of emissions intensity is defined as a firm whose activities have an emissions intensity above 2kt CO₂-e/\$ million revenue – the initial assistance level for these businesses will be set at around 90 percent of the average emissions per unit of output in their industry
- a moderate level of emissions intensity is defined as a firm whose activities have emissions intensities between 1.5kt and 2kt CO₂-e/\$ million revenue – the initial assistance for these businesses will be set at around 60 percent of the average emissions per unit of output in their industry.

This approach is predicated on providing encouragement to EITE industries in advance of the scheme's commencement to reduce their emissions, so they are rewarded by having a smaller carbon footprint relative to their competitors.

The Green Paper also indicates that the assistance provided to EITE industries should be gradually reduced over time, at a pre-announced rate to ensure that all parts of the economy contribute to the objective of reducing emissions.

New EITE investments are to be treated in a manner comparable to the treatment of existing investments.

Significantly, the Green Paper indicates that the Government's preferred position is to allocate up to around 30 percent of carbon pollution permits to EITE activities once agriculture is covered and 20 percent until that time. However, if subsequent information indicates that the assistance parameters listed above would result in an allocation of permits above or below 30 percent of national emissions, the parameters for assistance would need to be recalibrated.

Furthermore, if a business which received assistance under the provisions for EITE industries ceased to operate in Australia, its supply of free permits would also cease.

Low income households

It is considered that there are significant adjustment costs of the scheme for Australian households because the carbon price will inevitably flow onto households. To address these income distributional effects measures have been considered to assist households and particularly low income households in order to give them time to adjust to the scheme. These measures include:

- an off-setting cut in fuel taxes on a cent-for-cent basis with the adequacy to be assessed periodically for three years after which the adjustment mechanism itself is to be reviewed
- the provision of assistance to low and middle-income households through the tax and payment system
- provide additional support through the introduction of energy efficiency measures and consumer information to help households reduce energy use to address the perceived market failures in this area (i.e. insulation, hot water heating and other appliances, lighting and cars).

Longer term measures will be assessed through the upcoming comprehensive review of Australia's tax system.

How is the scheme linked internationally?

There is an emphasis on linking the Australian scheme with overseas schemes in order to contribute to an overall global solution of reducing net emissions. A longer term integration (open linking) is preferred. By linking to overseas schemes there is a broadening of the range of available abatement options and this will aid in reducing the overall global abatement costs.

There is consideration of short-term implementation risks in dealing with linkage (i.e. reliability in monitoring, reporting and verification of other countries). For this reason, it is proposed that there be a limit on the number of international offset credits that can be surrendered for compliance related purposes (i.e. CERs (Certified Emission Reduction), ERUs (Emission Reduction Unit), RMUs (Removal Unit) and non-Kyoto units). These limits will be announced in the context of the White Paper for the period 2010-11 to 2012-2013.

It is not proposed to allow the export of Australia Kyoto compliance credit as this would place upward pressure on domestic credit prices. It is the intention that the White Paper will contain the provisions and relevant restrictions that might apply to the conversion of Australian permits to Kyoto units for transfer to other countries for the period 2012-13 to 2014-2015.

What grants and other funding are available for industry?

A Climate Change Action Fund will be established. This fund will focus predominately on those industries not entitled to free permit allocation, but which require assistance to adjust to the carbon price.

A key issue to be determined is the amount to be made available in the fund. Clearly, the funding level will have an impact on the level of industry participants.

What is the role of the fund?

Support under the fund will be provided in two components:

- firm specific support
- support directed to particular workers or communities.

This is anticipated to be in the form of grants or broader industry wide measures. Regional community assistance provides for 'as necessary' support regardless of whether particular businesses in an affected industry have received support.

Partnership funding

There is a proposal included for 'partnership funding' for a range of activities including:

- capital investment in innovative new low emissions processes
- industrial energy efficiency projects with long payback periods
- dissemination of best and innovative practice among small to medium sized businesses.

Partnership funding eligibility criteria

These requirements do not appear to adopt the criteria necessary for the R&D tax concession or R&D offset and could conceivably operate independently. For example, it is possible that off-the-shelf low emissions technologies purchased by companies may fall within the criteria.

The Green Paper does not propose a framework or plan for how this money will be administered or on what basis funding decisions will be made. There is no discussion of access to the Climate Change Action Fund being a competitive or non-competitive grant.

How does the fund operate?

Administration of the Climate Change Action Fund is not addressed. There are, as yet, no objective criteria for determining the entitlement for this type of funding or the impact of participating in any other new or existing industry structural assistance program.

The Government will take into account the outcomes of the Strategic Review of Australian Government Climate Change Programs ('The Wilkins Review') and the COAG assessment of complementary measures in the final design of the fund. It is the Government's position that state based carbon schemes be discontinued once the national scheme is enacted.

What are the tax implications?

The Green Paper outlines the Government's preferred position to develop a new set of tax rules for the treatment of eligible compliance permits ('permits') to support cost-effective reductions in GHGs in a tax neutral and relatively simple manner. KPMG will continue to be involved in the ongoing consultations with Treasury, the Australian Taxation Office and the Department of Climate Change in the further development and refinement of these new rules. The Green Paper also discusses the Government's stated commitment to introduce cuts to fuel taxes to offset the initial price impact on fuel associated with the introduction of the scheme.

Income tax

The Green Paper outlines the Government's preferred approach in relation to the income tax treatment of permits, direct government assistance for liable entities and penalties for non-compliance. Areas that may be of particular interest to business include the tax treatment of free permits and government grants. Businesses may also wish to investigate further other areas not canvassed in the Green Paper such as the proposed tax treatment of early abatement expenditure and the potential application of state and territory stamp duties to permit transfers.

Treatment of permits

The Green Paper introduces the 'rolling balance method', which uses principles akin to the trading stock rules and has the effect that any expenditure on permits only impacts taxable income in the year the permit is used/disposed. It outlines the rolling balance method as follows¹:

- the cost of a permit would be deductible when the permit is acquired
- the proceeds from selling a permit would be assessable
- any difference in the value of permits held at the beginning of an income year and at the end of that year would be reflected in taxable income, with:
 - any increase in value included as assessable income
 - any decrease in value allowed as a deduction.

Without indicating a preference, the Green Paper proposes two methods for calculating the value of permits held under the rolling balance method being either:

- the *historical cost method* under which the value of the permit would be equal to the permit's original cost of acquisition
- the *market value method* under which the closing value of the permit would be equal to the market value of the permit at the end of the income year.

These two methods may give rise to different outcomes for some taxpayers depending on their particular circumstances.

¹ Extracted from paragraph 11.5.1 of the Carbon Pollution Reduction Scheme Green Paper

The preferred approaches for the income tax treatment of permits may be broadly summarised as follows:

Activity	Tax treatment
Purchase of permit (including future dated permit)	Deductible in year of purchase, however if held at year-end, its value is included in the 'rolling balance'.
Banking of permit	Deduction effectively deferred until permit is surrendered or sold under the 'rolling balance method'.
Surrender of permit	Under the 'rolling balance method' deductible in year surrendered.
Sale of permit	Sale proceeds treated as assessable income in the year of sale.

Treatment of free permits and cash grants to liable entities

The preferred position outlined in the Green Paper is for the value of free permits issued to liable entities to be included in assessable income in the year in which the permit is received. (New rules will be required to value such permits.) Where these permits are surrendered in the same year, the Green Paper proposes a new rule to allow the taxpayer to claim an offsetting deduction equal to the amount included in assessable income so there is no net tax liability. Further, it is also proposed that a taxpayer would not be disadvantaged if the first surrender date after receipt of the free permits falls in the next income year. Free permits that are banked would come under the 'rolling balance method'.

The Green Paper acknowledges that this could create cash-flow problems for taxpayers allocated permits which, for various reasons, they could not surrender in the short term (e.g. permits with a future vintage). It notes that taxpayers may be able to sell permits to reduce any such adverse cash flow impacts.

The proceeds on the sale of free permits are proposed to be treated as income assessable in the year of sale.

In relation to any cash grant given to a liable entity, the preferred position is that the value of any such grant would be included in assessable income in the income year it is received.

Penalties

Consistent with current Australian tax law, the preferred approach is that no tax deduction be available for a penalty incurred in relation to the scheme. We note that in calculating the level of any penalty, the Government should give consideration to factoring in the after-tax impact, that is, the cost of non-deductibility of the penalty.

Goods and Services Tax

The Green Paper states that the application of the normal GST rules (i.e. taxation and credit) will avoid complexity and minimise compliance costs. It goes on to assert that the approach 'minimises the incidence of entities being unable to offset any GST paid on business inputs'. The policy seems to be that transactions in permits ought not contribute to the GST base.

The statement that entities will 'generally be able to claim an input tax credit equal to any GST included in the price of permits' seems to be based on the following assumptions:

- all entities that are involved in the scheme will be registered for GST
- acquisition of permits will be made in carrying on the entity's enterprise
- acquisition of permits will not relate to supplies that would be input taxed or be acquired for a private or domestic purpose.

Applying the 'normal rules' to the transactions in permits will involve compliance and cash flow costs together with the risk of 'sticking tax costs' even though the clear policy would seem to be that transactions in permits should not contribute to the GST base. Perhaps further consideration in the forthcoming consultation process might be given to treating transactions in permits as a non-supply for GST purposes rather than to subject them to tax only to refund the tax to the purchaser.

The Green Paper's preferred approaches for the GST treatment of permits may be broadly summarised as follows:

Transaction	GST payable by supplier	Input tax credit entitlement for purchaser
Transfer of permits	Yes	Yes
Auction of permits	Yes	Yes
Surrender of permits ²	No	No
Issue of free permits	No	No
Imports of eligible compliance permits	No	No
Receipt of unconditional government assistance including cash grants	No	No
Payment of penalty for non-compliance	No	No

Cuts in fuel taxes

Recognising that there will be adjustment costs for Australian households, the Government announced it will cut fuel taxes (i.e. fuel excise) on a cent-for-cent basis to offset the initial price impact on fuel associated with the introduction of the scheme. The adequacy of this mechanism will be assessed periodically and adjusted accordingly for three years. It will be reviewed at the end of three years.

The Green Paper also indicates that assistance will be provided to rural and regional areas by way of the provision of an equivalent rebate to agricultural and fishing industry businesses for three years. Rebates are required as the excise system effectively does not apply to these sectors.

For heavy vehicle road users, the Green Paper indicates that fuel taxes will be cut on a cent-for-cent basis to offset the initial price impact on fuel associated with the impact of the scheme. The Government will review this measure after 1 year.

² This is on the assumption that the permit is surrendered for nil consideration

What are the accounting implications?

Assurance

The Green Paper acknowledges that effective reporting and compliance will be critical to the successful operation of the scheme. A key component of this is the level of assurance provided over entities' reporting. The preferred approach of the Government is for large emitters (>125kt CO₂-e) to have their emissions reports covered by mandatory assurance from independent third parties. This is seen as a balance between the benefits of assurance and the costs of compliance.

The assurance framework is likely to be based on that applicable to the existing NGER Act. This framework is currently still under development. Given the broad coverage of the scheme, including certain sectors (e.g. waste) where measurement is acknowledged to be difficult, the practical implications of providing a robust level of assurance needs to be carefully considered.

KPMG welcomes the Government's objective to align financial and emissions reporting systems, given that the scheme is likely to lead to assets and liabilities appearing on companies' financial statements which are then subject to financial audit.

On commencement of the scheme, the recognition of (potentially material) emissions liabilities on the balance sheets of entities which are subject to audit raises a specific issue in relation to assurance levels and timing. Under Auditing Standards, financial auditors may be required to obtain a high level of assurance (i.e. positive assurance) over these emissions liabilities in order to provide an unqualified audit opinion over the financial statements as a whole. Therefore, positive assurance over emissions obligations may be required for all covered entities subject to audit. Furthermore, this assurance will be required as at an individual entity's reporting date, which may not coincide with NGER Act reporting deadlines. Ultimately, it would appear, statutory requirements for financial statement audits may obviate the Green Paper's discussion on which companies are required to have their emissions reports assured and when.

Accounting guidance

The Green Paper does not enter into the debate around accounting for carbon pollution permits, however, it does:

- acknowledge that there is currently no specific accounting guidance in relation to emission permits
- calls for specific guidance to be provided by standard setters prior to the commencement of the scheme.

The structure of the proposed scheme, however, does mean that different accounting treatments will be applied within Australia. The treatment of free allocation of permits differs from that of auctioned permits. In summary, under current accounting standards free allocation of permits would give rise to government grant accounting, whereas auctioned permits do not. Therefore, accounting treatments applied by EITEs and SAIs will differ from the treatment applied by other scheme participants.

The International Accounting Standards Board has indicated that it expects to issue an exposure draft in relation to emissions permits during the second half of 2009, with a final standard due in 2010. Covered entities should ensure that they stay abreast of potential accounting treatments and seek financial advice on financial statement implications.

How will the scheme be governed?

The Green Paper indicates that an independent statutory body will be established to oversee and regulate the scheme. This Regulator will, however, be under the direction of the responsible Government Minister and certain matters such as setting the overall emissions cap and future emissions trajectory will be the domain of the Government.

In terms of the roles which will be assigned to the Regulator, these are expected to include:

- maintaining a national registry for carbon polluting permits
- holding auction events for carbon polluting permits on a periodic basis in accordance with policy decisions
- making determinations on the allocation of free permits to emission-intensive trade-exposed entities, and possibly in relation to any claims for offset credits
- monitoring the emissions reports submitted by participants in the scheme when permit acquittal (or surrender) is due
- Initiating compliance and enforcement action against participants who have not met their permit acquisition and/or acquittal obligations under the scheme.

In relation to the final point above, it is expected that the regulator will be given a range of compliance, investigative and enforcement powers, with the flexibility to select from a set of graduated options to respond proportionately to instances of non-compliance including financial penalties.

The Green Paper indicates that a process of periodic and independent public reviews will be undertaken to enhance the accountability and transparency of the scheme's governance arrangements.

In relation to implementation, the Green Paper reaffirms a 2010 start date for the scheme, and notes that many key elements of the scheme are already in place under the NGER Act, such as a requirement for reporting of emission levels by significant emitters.

How does this align with other government programs?

The preferred position expressed in the Green Paper, is to work with COAG and review existing policies. Some reference is made in part to the Wilkins Review. The Garnaut Draft Report, the Task Group on Emissions Trading (TGET) proposal and the National Emissions Trading Taskforce (NETT) proposals all discuss a complementary measure to address market failures. All of these reports refer to investment in low emissions R&D.

The TGET report proposes carefully targeted assistance beyond the R&D stage.

The Green Paper does not focus on the opportunity arising from the permit allocations to fund specific R&D incentives or concessions in the area of renewable energy, reduced carbon emissions or reduced electricity consumption.

Potentially this is due to the Government recognising the role of the existing R&D Tax program.

The existing R&D tax concession would provide a 125 percent deduction to claimants seeking to engage in all eligible R&D including reduction in carbon emissions or electricity consumption. No mention of increasing this base deduction for climate related research and development has been promoted or discussed.

Where to from here and how can KPMG assist?

The impending deadline for submissions on the Green Paper is 10 September 2008. KPMG has a dedicated team of professionals who can assist businesses to quickly respond to and manage the implications of the scheme by delivering a range of climate change and carbon risk advisory services, including:

- providing comprehensive summaries of the impacts on specific sectors to support submissions to government
- assessing the impact on your individual business and helping you to get ready
- assisting to identify opportunities to access government funding and grants for climate impact minimisation strategies or activities
- assisting with robust scenario planning and benchmarking regarding the impact of trajectories and permit prices
- advising on appropriate systems and reporting for effective monitoring of carbon exposures.



Contact us

For assistance, contact KPMG's dedicated hotline for all Carbon Pollution Reduction Scheme queries on +61 3 9288 5756. Alternatively, contact one of the following KPMG professionals.

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