Law Council
OF AUSTRALIA

30 September 2011

Committee Secretary
Joint Select Committee on Australia's Clean Energy Future Legislation
PO Box 6021
Parliament House

Via email: jscacefl@aph.gov.au

Dear Sir or Madam,

I refer to the appearance before the Committee last Monday 26 September 2011 of the Chairman and two members of the Law Council's Working Party on Climate Change, a joint working party of the Business Law Section and the Legal Practice Section of the Law Council of Australia ('the Working Party').

Further to that appearance, the Working Party commends to the Committee those parts of the submission lodged with the DCCEE by the Law Council on 22 August 2011 (the Submission) which were not adopted and incorporated in the Bills as introduced earlier this month.

In particular, the Working Party remains concerned about the different treatment of Joint ventures (which the WP accepts as effective to achieve policy objectives) and Partnerships (which are treated far less favourably), Joint Ventures and Obligation Transfer Numbers. JVs and Partnerships are commonly used to manage electricity generation, and other substantial, facilities and there does not seem to be any reason why the participants should be treated differently. This is discussed further at 2.0 below.

The second area where the Working Party considers the Package requires amendment concerns the taxation treatment of those who hold emission units. Those provisions create tax liability for holders of units in ways which contradict the fundamental principles underpinning the income tax and GST legislation, in that they, among other things:

(a) Tax the increase in value of an emission unit over a year, when it has not been sold or otherwise disposed of, and

(b) Treat the moving of international units into Australia, where ownership does not change, as a sale for CGT purposes.

(a) is no different from taxing the owners of shares on the ASX on the increase in value of the shares each year. Such a provision applied to shares would see the owners having to pay tax each year the shares increased in value, even if they never sold the shares.

(b) Appears intended to penalise those who seek to bring international units to Australia to satisfy their liability and act as a deterrent to doing so.

Both types of provision appear to have as their objective allowing the government to profit from the increase in value of units held by industry. Not only will the government receive the initial price of a unit when sold or auctioned, but it will also participate (at the expense of the holder of the unit) in any subsequent increase in value of the unit.

The irony is that if the unit increases in value, then so too must the quantum of liability it has been acquired to satisfy so there is no net gain to the holder of the unit – but he or she will nonetheless be taxed on the notional increase in value of both the unit and the liability.

Dealing with the taxation issues first:

1. Taxation issues

The Working Party reiterates the points made in the Submission, and provides the following comments and amplifications (using the same numbering system):

1.2 Para 9.1(a) Accounting principle 4 in proposed s 420-5

This provides:

"You must bring to account any difference between the value of your registered emissions units held at the start and at the end of the income year. This is done in such a way that:

(a) <u>any increase in value is included in assessable income</u>; and

(b) any decrease in value is a deduction."

If that principle were applied to shares or investment property, it would mean that both long and short term owners of those shares or property would have to pay tax on the increase in value every year, regardless of whether they were disposed of or not in that year.

Put another way, despite there being no profit made because the unit in question has not been sold, the scheme treats the asset as having been sold, and a profit made, when it has not been sold and no profit made.

1.3 Para 9.1(c) – Treatment of incoming international units

Normally, CGT is imposed when an entity disposes of an asset to a third party. This provision differs from that approach by making an entity pay tax on a unit they own at all relevant times, not only on the increase in value of a unit in a year (assessable income) but also CGT on any increase in value of the unit between its acquisition and transfer to Australia. That is to say, despite a single entity not disposing of the unit, simply moving it from another country to Australia is taken to be a sale and repurchase. There has been no capital gain realised as it has not been sold or disposed of yet a tax, calculated on a deemed disposal, is payable.

1.4 Para 9.2(c) - Mismatch where registration of a transfer of units is delayed

The treatment of a transfer as being made when the possibly delayed decision of the Regulator is made, rather than when it was sought, has potential to create a liability where none should exist. To illustrate, an entity may decide to surrender a unit on the last day permitted for same. If registration is delayed, the entity would then be in breach of the requirements, and subject to an automatic penalty, through no fault of their own. The transfer should be dated when sought.

1.5 Para 9.2(h)

A first-in-first-out (FIFO) assumption approach works for some purposes unconnected with the Clean Energy Scheme, such as where particular items to which the assumption is applied are indistinguishable from each other. One example would be identical ball bearings. However, it does not work where the assets to which the assumption is applied have “vintages” and where each is clearly identifiable, by its unique identification number.

Applying the assumption here creates unnecessary and problematic anomalies, resulting in an entity being assumed to hold units of which it has disposed, and not holding units which it does hold. This is a dangerous and unnecessary fiction.

2. Partnerships

2.1 Partnerships and unincorporated joint ventures are treated differently in terms of the imposition of carbon liability yet, for economic purposes, they are substantially the same – that is, they are both unincorporated enterprises that are carried on by two or more participants. It is undesirable that the incidence of carbon liability should vary in a way that depends (quite fortuitously) on the nature of the structure that is adopted.

(a) <u>Issue 1: the treatment of partnerships where operational control rests with an operator</u>

Where an unincorporated joint venture's emitting facility is under the operational control of an operator, with the result that the operator bears the carbon liability for the facility's emissions, that liability can be transferred to the joint venturers in proportion to their joint venture interests through the Clean Energy Regulator declaring the joint venture to be a declared designated joint venture. Such a declaration is made on application by the joint venturers to the Regulator with the consent of the operator.

Conversely, where a partnership's emitting facility is under the operational control of an operator, the only way in which the carbon liability for the facility's emissions can be transferred from the operator to a partner is through the Clean Energy Regulator issuing a financial control liability transfer certificate in respect of the facility. However, such a certificate only enables <u>100%</u> of the carbon liability to be transferred to <u>one</u> partner. This is not a satisfactory result.

Proposal: unincorporated joint ventures should be defined to include (rather than exclude) partnerships. Alternatively a partnership could be treated as a single "person" to whom this carbon liability could be transferred, with the result that each partner would be jointly and severally liable for the facility's carbon liability. This would be consistent with the treatment of partnerships in other Commonwealth legislation. For example, for the purposes of financial services regulation, a partnership is treated as a single person but the relevant obligations are imposed on each partner and may be discharged by any partner (see Corporations Act, s.761F).

(b) Issue 2: the treatment of partnerships where operational control does not rest with an operator

Where two or more persons have the authority to introduce and implement operating, health & safety or environmental policies for an unincorporated joint venture's emitting facility, and none of them has operational control over that facility (because none of them has the greatest authority to introduce and implement operating and environmental policies for the facility), the joint venture will be a mandatory designated joint venture. This situation could arise where there is no operator appointed for the joint venture and/or the joint venturers (through the joint venture management committee) jointly introduce and/or implement operating and environmental policies for the facility. In such a case, carbon liability for the facility's emissions is imposed directly on each joint venturer in proportion to their respective joint venture interests.

Conversely, where the partners in a partnership face the same situation, they are required to nominate one of their number as the partner that will assume 100% of the carbon liability for the facility's emissions. If they fail to make such a nomination, each partner will be liable for a monetary penalty and each partner will be responsible for an equal share of the carbon liability for the facility's emissions. This is an unsatisfactory position, and is of particular importance because the operations of partnerships are often conducted by the partnership itself rather than by an operator appointed by the partners.

Proposal: unincorporated joint ventures should be defined to include (rather than exclude) partnerships. Alternatively a partnership could be treated as a single "person", with the result that each partner would be jointly and severally liable for the facility's carbon liability. This would be consistent with the treatment of partnerships in other Commonwealth legislation. For example, for the purposes of financial services regulation, a partnership is treated as a single person but the relevant obligations are imposed on each partner and may be discharged by any partner (see Corporations Act, s.761F).

3. Joint ventures

Issue: carbon liability where the relative interests of participants in an unincorporated joint venture change.

It appears that the introduction of a new participant into, or the exit of an existing participant from, an unincorporated joint venture will result in there being a new joint venture for the purposes of the *Clean Energy Bill*. The consequence of this is that:

- where the joint venture is a mandatory designated joint venture, the Clean Energy Regulator must be notified of the change in composition of the joint venture within 30 days (ie. must be notified of both the creation of the new joint venture and these cessation of the old joint venture) and the joint venturers must apply to the Regulator for a new participating percentage determination; and

- where the joint venture is a declared designated joint venture, the Clean Energy Regulator must revoke that declaration and the joint venturers will need to apply to the Regulator for a new participating percentage determination.

These are (unnecessarily) administratively cumbersome requirements. However, an advantage of this approach is that it does make it clear that there is a separate "control" period for the joint venture (see *Clean Energy Bill*, ss.21(1)(a), 24(1)(a)) that corresponds with the period for which it maintains the same composition. This, in turn, means that each joint venturer will be liable for its joint venture share of the carbon liability attaching to the facility's emissions during each such control period.

The problem is that such an allocation of liability does not apply where the composition of the joint venture does not change, but the relative joint venture interests of the existing joint venturers changes, eg. as where one joint venturer sells part of its interest to another (existing) joint venturer.

<u>Proposal:</u> for the purposes of an unincorporated joint venture, the control days should be defined by reference not just to the existence of the joint venture but also by reference to the period for which a participating percentage determination applies in respect of the joint venture.

4. Obligation transfer numbers

Where a natural gas supplier supplies natural gas to another person through a natural gas supply pipeline, and it may reasonably be expected that the natural gas is for use in a large gas consuming facility, that gas is required to be supplied under the purchaser's OTN, with the result that the purchaser assumes liability for the greenhouse gas emissions embodied in the natural gas (*Clean Energy Bill*, ss.55B, 59(4), 60(4)). Such an OTN holder can also use that OTN to purchase natural gas for use in other facilities <u>if</u>:

- the supplier agrees to accept the OTN (*Clean Energy Bill* , ss.56; 59(2), 60(2)); and

- the purchaser has <u>operational control</u> over a facility (*Clean Energy Bill*, s.56(1)(d)).

These provisions are problematic in the not uncommon circumstances where one entity in a corporate group purchases natural gas in bulk which it then provides to other group members for use in their facilities. Such a "bulk gas purchaser" will typically not itself operate any facilities.

The threshold issue is that, for the operation of the OTN to be effective to transfer liability, the natural gas supplier must be liable for the embodied greenhouse gas emissions in the first place. However, section 33(1) of the *Clean Energy Bill* provides that such liability will only arise where:

- the natural gas supplier supplies natural gas to <u>another</u> person (s.33(1)(a)); and

- it may reasonably be expected that the natural gas is wholly or partly for use by <u>the</u> other person (s.33(1)(b)).

In the circumstances described above, the bulk gas purchaser will not itself be using that gas. Accordingly, the premise on which such a purchaser should be required to use an OTN (ie. the assumption that the natural gas supplier is liable for the embodied emissions in that gas) is incorrect. However, putting this aside (as the intention of the Bill seems to be that there should be liability in this case), there is a further issue.

This issue is that the bulk gas purchaser should be entitled to use the OTN that it obtains by virtue of it purchasing natural gas for a large gas consuming facility for all of its gas purchases (including for other facilities). In this regard, it is likely that all of this gas (ie. for both the large gas consuming facility and other facilities) will be purchased by the bulk gas purchaser as a "block" under the one gas supply contract. However:

- the requirement that the purchaser must have operational control over a facility before it can use an OTN for the gas purchased for facilities other than the large gas consuming facility means that the bulk gas purchaser cannot use its OTN for this purpose; and

- even if the bulk gas purchaser could use its OTN for that purpose, the supplier is not obliged to accept the purchaser's quotation of it OTN.

These outcomes mean that it will be necessary to distinguish between gas purchased for use in a large gas consuming facility and gas purchased for use in other facilities, with the potential that an OTN must be quoted for the former but cannot be quoted (or may not be required to be accepted) for the latter. Where the gas is supplied under one contract:

- it will be very difficult to make this distinction (at least the natural gas supplier cannot be expected to know how the bulk gas purchaser allocates that gas within its corporate group); and

- it will be necessary to provide for a carbon-exclusive price for that part of the gas that is supplied under an OTN and a carbon-inclusive price for that part of the gas that is not supplied under an OTN – this will cause considerable contractual difficulties.

Proposal: leaving aside the threshold issue (referred to above) of whether the natural gas supplier has liability for the embodied emissions in natural gas that is supplied to a bulk gas purchaser for use (by another group member) in a large gas consuming facility:

(a) delete section 56(1)(d), as there is no reason to require the purchaser to have operational control over a facility (ss.56(1)(e)(i) and (ii) provide sufficient controls); and

(b) amend section 55B(1) to require the recipient to quote its OTN in relation to all supplies of gas that are made under the same contract pursuant to which the gas supplied for use in the operation of the large gas consuming facility are made – the corollary of this is that the supplier would be obliged to accept that quotation.

If you have any questions in relation to the submission, in the first instance, please contact the Chair of the Working Party on Climate Change, Mr Doug Young. Mr Young may be contacted by email: Doug.Young@YoungLaw.com.au or by phone: 0418 719430.

Yours faithfully,

W Grant

Bill Grant
Secretary-General