



Name of organisation:  
KPMG Australia  
17 April 2009

## SUBMISSION BY KPMG TO THE SENATE SELECT COMMITTEE ON CLIMATE POLICY

### “KEEP GOING”

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**Confidentiality:**

*Not requested*

**Date:**

*17 April 2009*

**This report contains 25 pages**

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## Executive summary

KPMG welcomes the opportunity to provide the Senate Select Committee on Climate Policy with an overview of our position on Climate Policy, including the implementation of the proposed Carbon Pollution Reduction Scheme (CPRS) as a policy mechanism to achieve environmental and economic targets.

We urge you to keep going with the tremendous progress that has been made and to maintain the momentum that has been building in the business community. A summary of our recommendations within this submission is below:

### Recommendations:

No.	Details	Page
1	Keep Going! Australia is leading much of the world in introducing a comprehensive ETS. Adopt a continued approach to prevent a stop / start outcome. It is important to provide business with some certainty about policy continuity.	6
2	Remove alternatives to an ETS from the discussion but strengthen complementary measures.	7
3	De-link the economic impact on business of the introduction of the CPRS for 2011 and partially in 2012 by a transitional approach with temporary allocation of permits at nominal or no cost and removal of penalties.	8
4	A comprehensive program of technology neutral complementary measures including the RET and support for the development and commercialisation of low emission technologies should be adopted recognising the limitations of an ETS alone in meeting the Climate Change goals.	15
5	Consider the whole range of complementary measures using a similar approach to the UK covering: adaptation, mitigation, carbon readiness support for business and specific financial incentives including taxation incentives to promote renewable energy investment and fuel efficiencies and development of low emission technology and infrastructure.	16
6	Implement an emissions cap transparency program through the release of annual National Greenhouse Accounts and continue with the announced emissions cap but better describe the challenge.	19
7	The allocation of permit revenue should be re-balanced to promote carbon efficiency in energy production and consumption, investment in new R&D and infrastructure and compensation.	21
8	The inherent inaccuracy in some aspects of emissions calculations should be acknowledged in the regulatory requirements.	21
9	A Carbon Reserve Bank should be established to supervise the flow of international credits.	21

10	Voluntary emission reduction and offsets need to be encouraged through the surrendering of AEU's (Australian Emission Units) under the CPRS or AAUs (Assigned Amount Units) under the Kyoto Protocol as part of the National Greenhouse Accounts.	22
11	The recommendations of the Carbon Assurance Task Force should be adopted so that the NGER Act and CPRS deliver reliable, "investment grade" data and financial information. Furthermore, to underpin public and market confidence in these initiatives, emissions data and related financial information must be subject to independent external assurance.	24
12	Adjustments to significant tax policy positions adopted under the CPRS should be made including: adopting GST free treatment for the trading of emissions units and a tax exemption for free emission units allocated under the direct government assistance program.	25

### **Economic risk as the rationale for policy**

Given our professional area of expertise, KPMG approaches this issue from an economic perspective. In this context, the science of climate change indicates the economic risks posed to Australia are both materially significant and proportionally higher for than for most other countries. These fall in two areas.

1. A level of physical climate change is now inevitable and the direct economic impacts of these changes - including to agriculture, infrastructure, water supplies, real estate and tourism - are substantial and higher than for many countries.
2. It is now inevitable there will be an effective global cost of carbon, whether through an agreed global mechanism or a series of trading schemes, tax systems, border adjustments etc. Australia's economy is trade dependent and has, relative to other wealthy nations, high emissions both per capita and per unit of GDP. Given these factors, an effective global carbon price will put us at a significant competitive disadvantage. We face the risk that our historic advantage – cheap fossil fuel energy - will become the opposite.

### **Decoupling energy and carbon from economic growth**

Given these economic risks, Australia needs to act to decouple energy and emissions growth from economic growth, or we will face steadily declining competitiveness as global carbon pricing and other controls increase.

We urge early action on economic grounds, as early action will be cheaper than later action due to the pace of change being more in line with natural capital cycles.

There is no good economic argument for delay. To quote the lead negotiator on climate change for the United States, Todd Stern:

*“...those who hang back and cling to a high-carbon path will be economic losers in the end because with the scientific facts of global warming getting worse and worse, high-carbon products and production methods will not be viable for long.”*

As well as reducing economic risk, this decoupling presents considerable opportunity for the Australian economy. There are significant opportunities to reduce costs across all sectors of the economy and also to gain competitive advantage by leveraging Australia’s natural strengths. We see economic opportunities in three key areas:

1. Opportunities in Terrestrial Carbon, including in soil carbon, soil char and forestry that could provide significant benefits to regional economies and to Australia overall, given our large land mass.
2. Opportunities in new renewable energy, including leveraging Australia’s established research and science leadership in this area and leveraging Australia’s natural advantages of large areas with high solar intensity.
3. Opportunities in energy efficiency to reduce costs in commercial, industrial and domestic sectors. An example of the economic benefits available at the domestic level is explained later in the submission.

In summary, given this range of economic risks and opportunities, KPMG supports keeping climate change policy a national reform agenda item of the highest priority. We also encourage early action, as we believe it is within the national interest to start decoupling economic growth from energy and emissions growth. This is best achieved through the CPRS being implemented from 1 July 2010 with:

- Some key design changes;
- An initial transitional period with allocation of permits at nominal or no cost to de-link the economic impacts from the its introduction because of the global financial crisis; and
- Strengthening the range of complementary measures.

# 1 'Keep going'

## 1.1 Structure of this submission

This submission has two components:

- Section 1 – which introduces KPMG's position on climate policy
- Sections 2 to 7 – which respond to the specific terms of reference.

## 1.2 No reason to delay in advancing Climate Policy

KPMG supports the Government in its resolve to respond to the serious challenge that climate change poses to our country and to all countries of the world.

It is our view that the momentum gained in developing climate policy in Australia, including the design of an emissions trading scheme (ETS) should be built upon. KPMG supports the passage of the Carbon Pollution Reduction Scheme (CPRS) legislation in 2009 and subsequent implementation according to the proposed timeline from 1 July 2010. This would remove a major source of business uncertainty which is currently acting as an obstacle to abatement activity, long-term business planning and investment in clean technology, alternative energy technology and energy efficiency.

There is no reason for further delay or inaction in regards to the design and implementation of an ETS, or indeed other climate policies and policy frameworks. Since 2006, there have been various consultations and reports regarding the possible design of a national ETS, including reports prepared by the National Emissions Trading Taskforce, Prime Ministerial Task Group, the Garnaut Climate Change Review, and for the design and implementation of the Government's Carbon Pollution Reduction Scheme.

In 2007, there was unanimous agreement by the then Commonwealth Government, the then Federal Opposition and state and territory Governments, to introduce a national ETS. To return to discussing whether an ETS should be the central policy to reduce Australia's carbon pollution in 2009 would be a significant step backwards and shows limited regard for the effort and costs invested in developing the policy thus far.

There are, however, improvements that can be made to the climate policy, the design of the CPRS, and the implementation plans. These are set out in Section 6.

### **1.3 Focus on the outcome**

KPMG believes that as the concept of the introduction of an ETS is agreed, differences in approach should not prevent its implementation according to the current timetable. All the major parties agree that urgent action is needed – the differences seem to be in timing of the introduction and the emission caps from 2011 to 2020.

It is imperative that we move swiftly and together in our response to climate change. A continued approach is required to achieve effective mitigation and adaptation, and priority should be given to achieve the passage of the CPRS legislation. A stop / start approach would further reduce business certainty.

### **1.4 Risks from delaying action**

Our industry experience is that business preparedness to address climate change issues is primarily in response to compliance risk. In general, few businesses have mature carbon strategies embedded in the organisation in advance of the coming carbon constraints.

Business needs certainty to justify investment, particularly with regards to such major issues as the CPRS. Further delay in implementing climate change policy may lead to business and industry deferring, abandoning or otherwise failing to develop their investment plans. The critical challenge for Government is to drive certainty and to keep the pressure on business response via a continued momentum and transitional approach.

The international response to climate change is building momentum and a carbon constraint in Australia is inevitable. The US House of Representatives has before it a climate change Bill drafted by the House Energy and Commerce Committee. Under the bill the US would embrace a cap-and-trade system for reducing greenhouse gas emissions and boost its output of electricity from renewable sources. US carbon emissions would be cut by 20 per cent by 2020 and 83 per cent by 2050, with 2005 as the base year. Whilst this is just an early step in a long process it provides some indication of the future direction with cap and trade policy parameters broadly comparable with those being implemented in Australia. Whatever the outcome of the Bill the US regional schemes, such as that in California, are likely to continue either on their own or as part of a national scheme.

It is essential that Australian businesses do not get left behind by international businesses having a greater experience of operating in a lower carbon economy, including under an ETS. The unique Australian environment means that our economy is likely to be greatly exposed to the deleterious physical impacts of climate change. Stalling Australia's climate change policy development now would ensure the opportunity is lost to influence outcomes in the international arena. Such a position of influence would be of great benefit to Australia, particularly in the lead up to the United Nations Climate Change Conference in Copenhagen in 2009.

Furthermore, delaying our response to climate change exposes Australia to unnecessary economic risk, as trading partners discuss strategies to protect their industries from other economies that do not implement "equitable" carbon costs. For example, the US Energy

Secretary has suggested the Obama administration should consider a 'carbon tariff' against countries that have not put a cost on pollution, when the US introduces its emissions trading regime.

The Government has committed to a broader reform agenda. Through this agenda, the Government has the opportunity to support our transition to a low-emissions economy. The risks and opportunities associated with climate change should be addressed now. Arguments to the effect that action must be delayed in response to the global financial crisis are delay tactics at best. History of the EU ETS introduction has shown that economic downturn is as good a time as any to implement reform changes, for example, many effective tax reforms have been successfully introduced towards the bottom of an economic cycle. Restructuring the Australian economy for carbon constraints will help re-position it as the economic cycle changes.

***Recommendation 1: Keep Going!*** *Australia is leading much of the world in introducing a comprehensive ETS. Adopt a bipartisan approach to prevent a stop / start approach. It is important to provide business with some certainty.*



## 2 The choice of emissions trading

### Terms of reference for the inquiry into policies relating to climate change:

- a. the choice of emissions trading as the central policy to reduce Australia's carbon pollution, taking into account the need to:
  - i reduce carbon pollution at the lowest economic cost
  - ii put in place long-term incentives for investment in clean energy and low-emission technology
  - iii contribute to a global solution to climate change

### 2.1 CPRS – VHS, not the “Betamax” solution

The discussion on an ETS versus a carbon tax is irrelevant. The world is moving to emissions trading as the model for carbon constraints, a carbon tax will be like the Betamax video tape, such a system won't be compatible with the rest of the world. For Australia, compatibility is critical because of our reliance on world trade and the high per capita emissions intensity of our economy.

**Recommendation 2:** *Remove alternatives to an ETS from the discussion but strengthen complementary measures*

### 2.2 Transitional path to the implementation of the CPRS

KPMG supports the Government's intention to implement an ETS (the CPRS) as a key policy instrument to reduce greenhouse gas emissions within a broader policy agenda. Furthermore, KPMG supports the passage of the CPRS legislation during 2009. It is our view that this will motivate business to develop low-carbon strategies.

KPMG recognise that complete implementation of the CPRS by 2010 will prove difficult for business due the impacts of the global financial crisis on business confidence, profitability, cash flows and the availability of credit. Accordingly, KPMG believes a soft transitional approach is needed without putting back the achievement of the agreed emissions caps.

Australia has an emissions intensive economy making it very vulnerable to the globalisation of carbon pricing. It is therefore prudent for the Government to act early to avoid dictation by emerging global agreements that do not suit the Australian economy and to allow the time required to prepare and shift our economy to one that has low reliance on carbon.

Two transitional options have been outlined below.

### **Implementing the 2010 proposed CPRS start date as a dry run**

This option would involve de-linking the introduction of the CPRS with the cost imposition on business because of the global financial crisis and could involve:

- 2010 as a transitional year to start the scheme
- moving to partial compliance in 2011, with 2012 full compliance.

This approach could include allocation of permits at no cost, the removal of data accuracy requirements in early years, and the removal of director liabilities (as Garnaut suggested, a \$5/\$10 penalty). Benefits of this approach include: a closer alignment with Europe where the majority of permits are allocated and a continuation to driving business preparedness for carbon constraints. The risks associated with this option include potential for increases in fuel and electricity prices to consumers when the costs have not yet been incurred. The Government, having not raised revenue through the auctioning of permits, may not be in a position to provide consumers with compensation or household assistance. As a result, greater Government intervention may be required.

### **Delaying the start of the proposed CPRS to 2012**

KPMG do not support this option because:

- The risk of delaying the start date of the CPRS to 2012 is that entities will not take advantage of the time delay to prepare. We have already seen that many businesses are leaving preparations to the last minute. It also provides Australia with limited leverage in forthcoming international negotiations and prolongs business uncertainty. This could delay infrastructure and energy investments at a time when they are most needed.
- Other complementary policy options should continue to be implemented including, compensation mechanisms for CPRS, R&D and tax incentives, improved building and planning regulations, Energy Efficiency Opportunities, and renewables and energy efficiency incentives.

Mr Henry Derwent, President and CEO of the International Emissions Trading Association (IETA), has advised us that there has been no push in Europe for a delay in the EU ETS implementation timetable because of the global financial crisis, Australia should be no different.

***Recommendation 3: De-link the economic impact on business of the introduction of the CPRS for 2011 and partially in 2012 by a transitional approach with temporary allocation of permits at nominal or no cost and removal of penalties.***

### 3 Complementary measures

#### Terms of Reference for the inquiry into policies relating to climate change:

- b. the relative contributions to overall emission reduction targets from complementary measures such as renewable energy feed-in laws, energy efficiency and the protection or development of terrestrial carbon stores such as native forests and soils;

#### 3.1 A comprehensive climate policy is critical

Emission trading is, as we continue to argue, an important policy initiative that we strongly support. However, it must be considered as only one of many measures needed. Not only are we arguing that the other policy measures are necessary, we also believe that without them an ETS could create *new* economic risks – particularly the risk of under-investment in energy posed by excessive carbon price volatility. The UK example is worthy of consideration – the UK ETS implemented in 2002 has been supplemented by a range of other measures including: PFI credits, Credit Guarantee Finance, Prudential Borrowing, Renewable Obligation Certificates, Climate change levies, and a Shadow cost of carbon.

A comprehensive climate policy agenda approach in Australia needs to include both adaptation policy to deal with now inevitable climate change and mitigation policy to ensure Australia remains competitive as the world moves to a low carbon economy. Whether these measures are seen to be because of ‘market failure’, as described by Prof. Garnaut, or not they are still necessary as part of a comprehensive climate policy. Amongst the reasons we recommend this approach are:

- the fact that an ETS relies on price signals to change consumption and production but these price signals will not be fully transmitted through the entire economy as some sectors of our economy are characterised by imperfect, constrained or no market at all
- the relative insignificance to many consumers of these costs to together with the transaction costs and financing requirements to change consumption or production
- market failures associated particularly with the development and commercialisation of low emission technologies.

### 3.1.1 Adaptation policy

We need policy in a range of areas to address the physical risks and other changes that will be driven by a changing climate. Below are some examples, (this is by no means an exhaustive list).

- **City planning and design**

Given the forecast increases in heat, bushfire risks, drought, water shortages and rises in sea level, it will be important that our cities are planned to be 'climate ready'. The costs of later adaptation will be prohibitive. KPMG recently conducted a comprehensive review of planning for Adelaide in this context and identified many ways to address these risks that also bring economic benefits.

- **Economic risks of actual and perceived physical threats**

There are a range of economic implications of extreme climate events and rising sea levels that will require early intervention to manage. Examples include the risk of increasing insurance premiums leading to lower levels of coverage, and the risk of a run on assets that are exposed to rising sea levels. An example of the latter would be a rapid decline in valuations of coastal real estate when there is market acceptance of the likelihood of over one metre of sea level increases, with attendant economic consequences including lending risk.

- **Infrastructure protection and upgrading**

Rising sea levels, increasing heat and increasing storm risks all pose well definable risks to key transport, energy and water infrastructure. This requires a planned response well in advance of the physical impacts.

- **Agricultural policy, including shifting agricultural zones**

Changing weather and water supply patterns will create changes in agriculture, which if well planned, are manageable and could in fact create new opportunities. But strong early policy will be key to minimise social dislocation and economic loss.

- **Improving water management**

This area has been well articulated by many experts and is an area of deep experience within KPMG. It is clear we need a national water plan guided by the best science to avoid the disruption that will otherwise be caused.

- **Equity risks**

Climate change will disproportionately impact poor communities and low-income individuals. The ability to adapt is directly related to having income to relocate, increase insurance coverage, pay higher prices for carbon intensive products and for greater physical protection from extreme events. The existing distributional measures will need to be strengthened to spread these risks rather than concentrate them further.

### 3.1.2 Mitigation policy

Given the inevitable shift to a low carbon economy globally, Australia needs a range of policies to address the resulting economic risks and opportunities. These are broadly covered in the following areas.

#### 1. An emissions trading scheme

The establishment of effective, market based carbon pricing as proposed in the CPRS and discussed elsewhere in this submission.

#### 2. Tax policy

The application of tax policy to support and underpin a CPRS based price, including:

- Potentially providing an underpinning carbon price so investors have greater certainty against events such as the two price collapses in the EU Emissions Trading scheme and the 2007 price crash in the NSW GGAS Scheme, which were driven by a range of factors including economic.
- Ensuring tax policy supports the transition by aligning a range of existing taxes with the carbon reduction objective. This is covered more fully in section 3.4 of this submission.

#### 3. Complementary measures to support new energy technologies

We do not believe the CPRS will, by itself, provide adequate market incentive to drive new technology development without supporting policies. Without such policies it is inevitable there will be carbon price volatility including spikes. This is a prime reason why a trading scheme is necessary but not sufficient on its own to drive the change needed.

The solution in the CPRS design of a price cap is not a long-term solution as it effectively removes the emissions cap, thus undermining the key benefit of having a trading scheme (versus taxes) in the first place (certainty on the emissions outcome).

The best solution is to have a range of complementary measures that build a 'reserve bench' of technologies, to ensure they are sufficiently developed to roll-out when the price is high enough to justify mass commercialisation.

Therefore KPMG supports a range of policy actions – direct funding, tax support, R&D, supply and demand side rules, the use of government purchasing, and so forth, to support the development of new technology, covering all viable technologies.

These should wherever possible be technology neutral, market focused and driven by defined outcomes (e.g. support for zero CO<sub>2</sub> energy generation) rather than support for particular technologies (such as solar versus clean coal). A well-designed market is the best mechanism for choosing technologies.

The objective is to make permanent changes in consumption and/or production, even though there will be public pressure around increased prices. In the long term, compensation for increased costs will not be necessary if sufficient technology advances are made.

#### **4. A major focus on energy and fuel efficiency**

A comprehensive program on energy and fuel efficiency should be the most urgent and highest priority because of the considerable economic benefits in a recession, particularly in increasing competitiveness, job creation and freeing up consumer spending power.

KPMG has conducted a detailed analysis of domestic energy efficiency alongside the Brotherhood of St Laurence and we make this report available to the committee. While this report focused on low-income households, the lessons apply equally across the whole economy.

In summary, that report concluded that in NPV terms an \$8.7 billion investment (by government) in domestic energy efficiency would deliver a \$14 billion return to taxpayers via reduced energy bills, along with the creation of 40,000 jobs and the saving of 47 million tonnes of CO<sub>2</sub>.

We recommend comprehensive and significant programs by government in fuel and energy efficiency because the global experience indicates that the CPRS alone (for reasons such as those identified earlier) will have limited impact on driving either. This is because the impact on electricity and petrol prices will not be material in increasing the economic motivation to act, particularly given the price cap. For example, in energy efficiency, there are already many cases in the commercial, industrial and domestic areas where investments with paybacks of less than five years are not pursued, despite the implied 20% return on investment.

We are also supportive of energy and fuel efficiency measures across the economy because they lower the emissions reduction burden for other sectors of the economy.

#### **5. An early focus on terrestrial carbon including agriculture**

KPMG believes there are strong arguments in favour of early action by government on terrestrial carbon for economic reasons. We acknowledge the uncertainties in this area however we believe it is likely that Australia's economy could benefit considerably from developing its natural advantages in large-scale soil carbon and biomass for fuel and sequestration (including biochar).

There is even potential for Australia to ultimately be a global carbon sink if the science continues its current trend of firming up this area as a cheap way to sequester atmospheric carbon.

We believe the measurement accuracy is too low to allow this area's inclusion in the CPRS at this stage (except in reforestation). However we recommend a strong government focus on other measures to support Terrestrial Carbon because of:

- the significance to regional economic development
- the potential for Australia to gain a global competitive advantage
- the early science indicating potential for high volume low cost abatement.

One potential mechanism to drive this area would be to phase in the agricultural sector via a separate agricultural (or land based) carbon trading scheme. This would build capacity in accounting and managing agricultural emissions and sequestration but would avoid compromising the CPRS by being kept as a stand-alone scheme initially.

### 3.2 Looking at the UK

In KPMG's view the approach taken by the UK Government to the climate change policy issue is an example of how different climate policies can be integrated. The key features of the approach are listed below.

- The Climate Change Bill which laid the framework for action in reducing the emission of greenhouse gases in all subsequent policy developments.
- The Stern Review was instrumental in moving the climate change debate from the environmental to the economic. The fact that it was sponsored by HM Treasury and researched and written by a senior economic advisor greatly added to its gravitas.
- The overall climate change mitigation plan where the reduction planned and anticipated from the range of different policy measures is mapped out. This allows for a clear message about the role of the following: energy efficiency requirements, the contribution that aviation cap and trade could make, the indirect benefits of agricultural reform and the indirect impact of excluding GHG emission from water quality policy.
- The fast track implementation of carbon monitoring, metrics analysis and planning into the public estate and sector regulators. This included the major Government departments (defence, health and environment, regional development agencies) and the regulated sector such as the UK water utilities and the energy sector.
- The funding of a specialist organisation, "The Carbon Trust", that develops and provides information on carbon markets, policy and strategy directly to business (the Trust is funded from revenue raised from the Climate Change Levy). The Trust also provides funding to UK business to develop low carbon strategies and energy efficiency plans. Approximately 50 percent of the largest 100 UK listed companies have carried out some form of carbon strategy work in conjunction with the Trust. This has resulted in a significant level of carbon literacy in UK plc.

- The provision of regional leadership and support in the development of the detailed mechanisms of the EU ETS. Examples of this include the development of allocation benchmarks, the documentation of monitoring and reporting methodologies and the funding of research at top-level economic departments, (for example, the LSE, University of Cambridge) of climate change economics.
- The requirement for Local Government to develop climate change adaptation plans for their areas of control. These are based upon the impacts predicated in the detailed climate modelling carried out by the Hadley Centre and built into the UK Climate Impact Program (UKCIP) system that provides prediction for temperature, rainfall, etc, on a 1km resolution.

### **Case Study: The UK water sector**

The 15 companies that comprise the water utility sector in the UK are (with the exception of the operation in Northern Ireland) all private entities. Their operations are regulated by the Office of Water Regulation (OFWAT). Under this regulation every company is required to submit a plan that specifies how much it will spend on asset development over a five-year period. In the build up to the submission of their asset management plans for 2010 - 2015, (AMP 5) the companies were informed by the regulator that they had to achieve a reduction in the carbon footprint in line with the requirements of the Climate Change Bill. This impacted approximately \$25 billion worth of investment. The companies were supported in their development of the carbon aspects of AMP 5 in a number of different ways:

- The Carbon Trust provided research funding and access to subsidised specialist consultancy support.
- The environmental regulator provided a standardised set of metrics by which the carbon footprint of asset development (construction of water treatment facilities, pipelines etc.) could be determined.
- The water company research body worked to develop a standardised emission reporting tool that could accurately express the complexities of the different carbon flows.
- The implementation of a complementary renewable energy target and market in the associated certificates meant that the companies were able to plan for revenue streams from their investment in renewable generation over the five-year period.

### **3.3 Renewable energy targets**

As stated above, comprehensive and significant programs by Government are needed in encouraging alternatives to fossil burning fuel because, for reasons such as those identified above, the global experience indicates that the CPRS alone will have limited impact on driving investment in renewables. This is because the impact on electricity and fuel prices will not be material in increasing the economic motivation to act, particularly given the CPRS price cap.



The RET Scheme has been the subject of much debate and Treasury modelling last year showed that a carbon price of \$60/t is needed to make most renewables financially attractive but this may not occur for decades. For energy producers and wholesalers, the RET targets are a greater challenge than the CPRS price on carbon.

In addition to a range of incentives, there is also a need to remove planning barriers to renewable energy and clean technology projects and to better align planning policy and approval processes.

**Recommendation 4:** *A comprehensive program of technology neutral complementary measures including the RET and support for the development and commercialisation of low emission technologies should be adopted recognising the limitations of an ETS alone in meeting the Climate Change goals.*

### 3.4 Role of complementary tax in driving investment

The impact of the tax system on the environment needs to be understood and factored into the development of climate change policy in Australia. This includes an understanding of how retail fuel, coal and petroleum is taxed and how the tax framework can accommodate climate change initiatives to achieve neutral after-tax outcomes for participants.

Ideally, the tax system should reinforce policy outcomes, facilitate climate change initiatives by removing tax impediments and provide responsible tax incentives to drive appropriate climate change behaviour. The system should also ensure that no tax disadvantage arises where voluntary action is taken by business to respond to climate change measures, including the purchase of AEU's under the CPRS by non-liable entities as part of a carbon offsetting strategy.

The tax system, via targeted tax incentives, can play a significant role in promoting and instigating changes to corporate behaviour influencing responses to climate change. However, there is a need for clarity on how tax incentives can effectively kick-start and drive complementary measures (such as low emissions technology in industry and abatement infrastructure (e.g. carbon capture and storage)).

As renewable energy industries compete for global capital to fund new projects, competitive tax concessions are required to encourage changes to business practices to drive emissions reductions (e.g. in Australia the current tax depreciation write off period for wind farms is 20 years, compared to other countries which provide shorter more favourable tax write off periods such as in France where a 1 year write off has been provided to encourage development of wind farms). Such tax incentives may be considered a way of ameliorating the high risks and costs associated with capital-intensive projects.

Potential tax concessions suggested to kick start emissions reduction activities include a targeted investment allowance, increasing the deduction on eligible 'green' technology R&D expenditure to 200% and immediate tax deductions for specified abatement expenditure.

The tax system should be 'climate change friendly' by ensuring the introduction of new climate change initiatives do not result in adverse tax outcomes for both participants and the broader community. The tax system must therefore be flexible, pro-active and responsive in order to accommodate and facilitate action on climate change and to assist the system in progressively adapting to the challenges and unfamiliar concepts as they arise from climate change initiatives.

While consideration around appropriate tax incentives may be undertaken as part of the Henry Review of Australia's Future Tax System, any recommendations arising from the Henry Review are unlikely to eventuate until 2010 (or later). KPMG believes that the consideration and development of tax incentives to support the significant investment required by industry should be accelerated and released separately to align with the introduction of the CPRS.

Further commentary on the role of taxation is included on these points in Section 6.6 below.

### 3.5 Other complementary measures

Other areas for consideration include:

- "More transparent environmental markets are necessary, including transparency of corporate environmental information" (Source: Australia 2020 Summit – Final Report, p.68)
- The role of a 'Carbon Reserve Bank', an institution that does not change with Government and that can be used as a leverage to manage the carbon market and economic outcomes (refer Section 6.4 below).
- Establishing an Australian equivalent of the Carbon Trust that can build up the level of climate change mitigation and adaptation skills in the business sector.

**Recommendation 5:** *Consider the whole range of complementary measures using a similar approach to the UK covering: adaptation, mitigation, carbon readiness support for business and specific financial incentives including taxation incentives to promote renewable energy investment, fuel efficiencies and development of low emission technology and infrastructure.*

## 4 Environmental effectiveness

### Terms of Reference for the inquiry into policies relating to climate change:

- c. whether the Government's Carbon Pollution Reduction Scheme is environmentally effective, in particular with regard to the adequacy or otherwise of the Government's 2020 and 2050 greenhouse gas emission reduction targets in avoiding dangerous climate change;

#### 4.1 CPRS with design changes can be effective

KPMG believe that the CPRS can be environmentally effective with:

- the National Greenhouse Accounts initiatives set in Section 5 below
- the CPRS design changes set out in Section 6 below.

## 5 Mechanism to determine global emission reduction effort

### Terms of Reference for the inquiry into policies relating to climate change:

- d. an appropriate mechanism for determining what a fair and equitable contribution to the global emission reduction effort would be;

### 5.1 National Greenhouse Accounts

The public debate initiated when the emissions cap was released was largely ill-informed. This was because of a lack of understanding about the carbon intensity per capita in Australia and the public suspicion that not enough was being done, without a full understanding of where Australia stands with its emissions and the opportunities for abatement.

A transparency program is required to inform the public about Australia's National Greenhouse Accounts (NGA) and the impacts of the CPRS, RET, voluntary actions and the further opportunities for emission reductions. The NGA could assume the same status as the annual federal budget and be subject to the same scrutiny and debate around the targets and the 'surplus or deficit'. In this way the public would have much greater trust in the proposed emission caps and the debate would be much more informed.

### 5.2 Getting on with 5 to 15 percent

It is important to note that Australia's 5 to 15 percent reduction on 2000 levels by 2020 is actually a much tougher target than is acknowledged by those who advocate an unconditional 20 percent reduction. By concentrating on the five percent figure, the size of the task ahead for business has been mistakenly considered small by some commentators. The Prime Minister described the scheme as one of the most ambitious schemes anywhere in the world, and he is correct.

In real terms, taking into account the increase in economic activity since 2000, business will need to cut emissions by between 12 to 22 percent based on anticipated 2010 levels to meet this so-called 'easy' target. Australia's per capita reductions in emissions to meet the 2020 target exceed those Europe has set and are comparable to those the UK has committed to.

A headline target of 5 to 15 percent reduction in emissions by 2020 from 2000 levels actually requires a 20 to 29 percent reduction in the emissions the Department of Climate Change is anticipating would otherwise be the case in 2020. Consider this in the context that Australia has one of the highest emissions per capita rates in the world as a

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result of our mining and coal industries supplying the world with energy. This encourages debate about whether an ETS should be consumption based rather than production based which might suit Australia but would be inordinately more complicated if not impossible to implement and is an unnecessary debate as ultimately global agreement is required and in this circumstance there is no need to debate this aspect as they equate. The position that the current target is too low poses a real danger that the business community may have underestimated the amount of work required to meet these targets.

***Recommendation 6:*** *Implement an emissions cap transparency program through the release of annual National Greenhouse Accounts and continue with the announced emissions cap but better describe the challenge.*

## 6 Scheme design

### Terms of Reference for the inquiry into policies relating to climate change:

- e. whether the design of the proposed scheme will send appropriate investment signals for green collar jobs, research and development, and the manufacturing and service industries, taking into account permit allocation, leakage, compensation mechanisms and additionality issues;

### 6.1 Adjustments to the CPRS design

In our view there are a number of design changes that need to be made to the CPRS, some of which can be adjusted through regulation rather than legislation. These are:

- The transition period – see Section 2 above
- The use of permit proceeds
- The measurement and reporting accuracy levels
- The treatment of voluntary reductions and offsets
- The Carbon Reserve Bank
- Assurance, Tax and accounting treatments.

### 6.2 Use of permit proceeds

The Whitepaper, in Appendix E, shows that of the total permit revenue of around \$11.5 billion in 2010 only \$700 million (in the Climate Change Action Fund) will be directed back into the economy to build capacity to manage the transition to a prosperous low carbon economy (and green collar jobs). As noted previously, such an investment is necessary to promote adaptation strategies and infrastructure investment designed to directly reduce emissions.

The objective of compensating those impacted by the introduction of a carbon price is therefore limiting the investment in new R&D and infrastructure.

Proposed Government funding to assist businesses to transition to the carbon constrained economy under the CPRS does not include funding to help business understand and develop effective carbon strategies. The UK provided carbon grants to assist such development. KPMG supports such a strategy in Australia. Our experience

is that businesses in Australia are not prepared to participate in the CPRS and few have developed carbon abatement strategies.

**Recommendation 7:** *The allocation of permit revenue should be re-balanced to promote carbon efficiency in energy production and consumption, investment in new R&D and infrastructure and compensation.*

### 6.3 Measurement and reporting accuracy levels

Some of the measurement and reporting requirements of the CPRS and the NGER Act are unrealistic. For example, fugitive emissions from landfill, waste water and sewage sludge are based on a standard emissions factor of each activity. This raises issues in relation to whether the standard emissions factor is sufficiently accurate to meet the 95 percent criteria for reporting under the NGER Act and also limits the incentives for facilities to improve performance.

**Recommendation 8:** *The inherent inaccuracy in some aspects of emissions calculations should be acknowledged in the regulatory requirements.*

### 6.4 Carbon Reserve Bank

A Carbon Reserve Bank is needed to supervise the flow of international credits. There is confusion around the unlimited access to credits in international markets - the market may be flooded with foreign credits if they are unlimited, but the option of cheap reductions would be lost if they're not. A Carbon Reserve Bank could control these issues. Whilst CDM supply will be the issue, there is uncertainty around the CDM post 2012 Kyoto discussions so there may not be a flood of cheap CDM permits for many years yet.

The real issue for the Australian Government here is the loss of potential permit revenue offshore to CDM developers whilst it is still required to find funds for compensating households. The Government has committed to cash compensation in advance based on a carbon price of \$25/t. If the carbon price increases then compensation will go up, but if it drops below \$25 the compensation rate stays at \$25. This budget black hole could be substantial.

Consideration could also be given as to whether a Carbon Reserve Bank is needed to supervise: the secondary market, direct transactions and the permit derivative market. Whilst the new Australian Climate Change Regulatory Authority (ACCRA) would manage the auction process and the other elements of compliance with the CPRS legislation, activities of the Carbon Reserve Bank could possibly include these additional areas.

**Recommendation 9:** *A Carbon Reserve Bank should be established to supervise the flow of international credits.*

## 6.5 Treatment of voluntary reductions and offsets

The public debate around the impact of voluntary reductions on the scheme cap has been lost despite the point being irrelevant (because of its relative size) and ignorant of what the CPRS is designed to do (the whole premise of the CPRS is to invoke reductions in carbon intensive usage). A more significant aspect of voluntary action is the future of the voluntary market post the introduction of the CPRS. This market can drive substantial emission reductions and offset projects and can create innovation for the formal market. However activity in the voluntary market is slowing and is likely to cease when the CPRS is introduced under the current design.

The draft National Carbon Offset Standard has exacerbated this concern because it assumes carbon neutrality is an economy wide concept rather than an individual or entity concept thereby discouraging entities to seek 'carbon neutrality' as part of market facing strategy and create voluntary reductions and offset projects. KPMG in Australia has Greenhouse Friendly accredited 'Greenhouse Neutral' status and offsets its scope 1, 2 and 3 emissions through the acquisition of DCC accredited offsets on the voluntary market. Unless changes are made, we will cease this activity on the implementation of the CPRS. This is because the draft standard states that, because our actions will not change economy wide emissions, we will no longer be "Greenhouse Neutral", in addition we would pay for offsets that relate to emissions that are part of the cap and hence KPMG would pay twice – in the price of suppliers recovering permit costs and for offsets.

**Recommendation 10:** *Voluntary emission reduction and offsets need to be encouraged through the surrendering of AEU's (Australian Emission Units) under the CPRS or AAUs (Assigned Amount Units) under the Kyoto Protocol as part of the National Greenhouse Accounts.*

## 6.6 Assurance arrangements

KPMG supports the views of the Carbon Assurance Task Force<sup>1</sup> in stating that the NGER Act and CPRS must deliver reliable, "investment grade" data and financial information. Furthermore, to underpin public and market confidence in these initiatives, emissions data and related financial information must be subject to independent external assurance.

Below is a summary of the key features the members of the task force believe are a necessary component for the creation of a best practice assurance model. These points are drawn from the submissions sent to the DCC by the members of the task force and

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<sup>1</sup> This group comprises: CPA Australia, BDO Kendalls, Deloitte Touche Tohmatsu, Ernst & Young, Grant Thornton, KPMG, PKF, PricewaterhouseCoopers, The Institute of Chartered Accountants in Australia, and the National Institute of Accountants.



we understand are being considered by the Department in drafting the regulations around independent external assurance.

**Best-practice assurance model for external audit of greenhouse and energy information:**

- 1 Robust and consistent pre-lodgement assurance of carbon emissions is in the public interest – “investment-grade” data is required.
- 2 External audits to be conducted to a single Australian Accounting Standards Board (‘AUASB’) auditing standard linked to forthcoming international assurance standards updates.
- 3 Lead Auditor to possess appropriate and demonstrated competencies (based on principles-based competencies assessment model) and to be registered/accredited by the regulator. Registration/accreditation should apply to Lead Auditors only. The regulator should regularly re-assess Lead Auditors’ suitability, based on annual returns (as per ASIC’s RCA model)
- 4 Lead Auditor to be responsible for ensuring that the audit team possesses the competencies needed to perform the audit assignment. Audit teams should be permitted to comprise a mix of experience levels (to allow mentoring/training of junior staff).
- 5 Audits should be subject to a program of external review (professional association and regulator, as per ASIC’s Registered Company Auditor model).
- 6 Lead auditors should have minimum requirements set by regulation covering the following:
  - Quality control
  - PI insurance
  - Continuing professional education/development
  - Code of ethical conduct
  - Appropriate disciplinary procedures (professional association and/or regulator, as per ASIC’s RCA model)
  - Strict independence requirements.
- 7 Independence requirements should apply to all professional members of the audit team. Independence standards equivalent to Section 291 of the IFAC Code of Conduct should apply.

- 8 A standardised format should be adopted for audit reports, developed by the AUASB, that takes account of the differences between reasonable assurance, limited assurance and agreed-upon-procedures assignments, as well as specific assignments conducted pursuant to sections 73 & 74 of the NGER Act.
- 9 Audit reports should be signed-off by a single Lead Auditor and should not be required to name all members of the audit team, nor list conflicts of interest (as conflicts should not arise if appropriate independence requirements apply).
- 10 The model should provide for breach reporting requirements and qualified privilege on reported matters by auditors.

***Recommendation 11:** The recommendations of the Carbon Assurance Task Force should be adopted so that the NGER Act and CPRS deliver reliable, 'investment grade' data and financial information. Furthermore, to underpin public and market confidence in these initiatives, emissions data and related financial information must be subject to independent external assurance.*

## 6.7 Accounting matters

Following the withdrawal of IFRIC 3 in June 2005, there has been no specific accounting standard on accounting for emissions rights. This has led to differing accounting practices in countries (notably the EU countries) which have already implemented a cap and trade scheme. KPMG notes that the government used its CPRS White Paper to call on the International Accounting Standards Board ('IASB') to develop such guidance.

KPMG supports this call to the IASB, which replaces a previous request for the Australian Accounting Standards Board ('AASB') to issue such guidance. By following the IASB lead, this will ensure that Australian accounting standards (and entity financial statements) will continue to be harmonised as far as possible with international accounting standards.

KPMG notes, however, that an emissions-specific accounting standard is unlikely to be finalised prior to the commencement of a 2010 CPRS. Whilst we do not believe that this is a critical factor, we encourage the government to continue to lobby the IASB in this regard.

## 6.8 Tax matters

We have outlined below KPMG's response to some of the significant tax policy positions adopted under the CPRS. Specific tax issues arising from the mechanics of the draft tax legislation, *The Carbon Pollution Reduction Scheme Bill 2009*, have not been addressed herein on the basis that these have been discussed in detail in other submissions provided to Government. However, the following key tax policy concerns should be addressed:

Contrary to the broader CPRS policy objectives of encouraging international trade and attracting foreign entities to participate in the CPRS, the application of the current GST law to CPRS transactions is likely to give rise to significant uncertainty, compliance costs and unrecoverable GST. KPMG's preferred position is that the trading of registered emissions units and associated derivatives be GST free. This would assist in alleviating the uncertainty and complexity for stakeholders involved in import, export and derivative trading of registered emissions units. This should also assist in Australia becoming an international trading hub for emissions units and in the harmonisation of our CPRS with New Zealand's ETS, where emissions units are zero-rated under their GST rules.

Free emissions units allocated under the direct government assistance program are currently treated as taxable under the CPRS exposure draft legislation (contrary to previous submissions to Government) effectively diminishing the value of compensation provided to emissions-intensive trade-exposed industries ('EITE') and strongly affected industries ('SAI').

KPMG's preferred position is that free emission units should be exempt from tax to appropriately compensate entities in these affected sectors which will be most exposed and potentially most disadvantaged as a consequence of government imposed industry restructure and adjustment required under the CPRS.

If emissions units are not tax free, then, whilst not a preferred position, the taxing point should be deferred to the time of sale or final surrender to prevent unfair upfront taxation of a notional receipt.

It is also noted that treating free units issued to SAIs (coal-fired generators) as taxable, results in cash flow and timing disadvantages where those units are on hand at the end of the income year they are received. This cash flow disadvantage not only reduces the value of the compensation provided to SAI entities, but also requires taxpayers to consider alternatives (such as over surrendering and disposing units) to alleviate the disadvantages arising from the current tax treatment of free units. This is somewhat inconsistent to the broader policy objective of a simple and neutral tax framework that does not influence decisions regarding the acquisition, surrender or sale of emissions units.

As an alternative position, free units issued to SAIs should not be assessable until the tax year in which they are to be used, to acquit the obligations of the relevant entity or are sold in secondary market. This approach brings the treatment in line with the income tax treatment of free permits issued to EITE entities.

***Recommendation 12:*** *Adjustments to significant tax policy positions adopted under the CPRS should be made including: adopting a GST free treatment for the trading of emissions units and a tax exemption for free emission units allocated under the direct government assistance program.*

## 7 Related Matters

### Terms of Reference for the inquiry into policies relating to climate change:

f. any related matter

NIL