PASSING THROUGH CARBON COSTS UNDER THE CARBON POLLUTION REDUCTION SCHEME

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I INTRODUCTION

Australia is on the threshold of significant economic reform in response to concerns regarding climate change. It is therefore not surprising that climate change is now widely considered as a significant risk to business. Knowing about climate change is not enough. How well a company transitions into a carbon constrained future depends on its board and management being able to identify how climate change affects its operations, and having the ability to make changes and exploit opportunities in this regard. For this reason, climate change is not just an environmental issue or a compliance issue; it is a corporate governance issue that boards, having ultimate responsibility for the management of corporations and the objective of maximising shareholder wealth, should be actively concerned with.

The federal government's proposed Australian greenhouse gas emissions trading scheme, the Carbon Pollution Reduction Scheme ('CPRS'), is expected to commence in 2011. The CPRS proposes to impose an obligation on businesses covered under the scheme to avoid a 'unit shortfall' by surrendering a suitable number of Australian emissions units ('AEUs') or eligible international emissions units[1] ('EIEUs') at a cost — to match their annual greenhouse gas emissions.

While the direct costs of compliance will lie with liable entities, such entities will look to preserve their margins by 'passing through' their greenhouse gas emissions costs wherever they can. Consequently, a component of the price of all goods and services with a greenhouse gas emissions footprint will comprise an emissions cost, to a varying degree, as a result of the CPRS. A business' ability to pass on its costs to customers or counterparties will be affected by, amongst other things, the basis of contracting in a market. In many instances, this will be a matter of contractual negotiation as, unlike the Goods and Services Tax ('GST'), there is no legal assistance or framework to pass through emissions costs.

A liable business' ability and method of passing through its carbon costs will also be affected by whether it is eligible to transfer liability under one of the CPRS's two statutory pass-through mechanisms. These mechanisms are the Liability Transfer Certificate ('LTC') scheme and the Obligation Transfer Number ('OTN')

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1 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 132.

scheme. The LTC mechanism permits the transfer of CPRS obligations to other members of a corporate group or to the financial controller of a facility; the OTN mechanism allows upstream fossil fuel suppliers to transfer CPRS liability to downstream entities in the fossil fuel supply chain.

While the intent of the CPRS is to have the broadest possible coverage so as to 'reduce the overall cost to the Australian economy',[2] the CPRS fails to contain an across-the-board statutory pass-through scheme for the costs incurred in fulfilling CPRS obligations.[3] This, in addition to the limited circumstances in which the LTC and OTN schemes apply, means that a liable entity's ability to pass through such costs to customers and counterparties will be largely governed by the terms of its contracts.

Against this background, this article examines key statutory and contractual mechanisms to enable the pass through of carbon costs. Specifically, it evaluates each mechanism in light of the application of the CPRS and demonstrates their viability in practice. The first part of this article looks at statutory mechanisms pursuant to the CPRS — the LTC and OTN mechanisms; the second part then focuses on contractual mechanisms and considers the issues which are vital to effect carbon cost pass through.

II THE CPRS

A *Background to the CPRS*

On 10 March 2009, the federal government released exposure draft legislation for its proposed CPRS. The initial draft legislation closely reflected the policy position set out in the White Paper of 15 December 2008.[4] Subsequently, efforts to incorporate stakeholder consultation crystallised in significant amendments to the legislation as announced on 4 May 2009.

The 14 May 2009 saw the federal government introduce its bills into the House of Representatives for the establishment of the CPRS. Though these were passed by the House of Representatives (with certain government-moved amendments) on 4 June 2009, they were unable to earn the approval of the Senate and were voted down on 13 August 2009.

Most recently, the CPRS Bills were reintroduced into the House of Representatives on 22 October 2009 and were again voted down in the Senate on 2 December 2009. It is expected that the federal government will reintroduce the CPRS Bills in early 2010.

2 Australian Government, *Carbon Pollution Reduction Scheme — Australia's Low Pollution Future: White Paper Vol 1* (2008) 6-1 ('*White Paper*').

3 This is in contrast to GST provisions, where the system of 'taxable supplies' and 'credible acquisitions' ensures that GST costs pass through the supply chain (see ss 9 and 11 of *A New Tax System (Goods and Services Tax) Act 1999* (Cth)).

4 Australian Government, *White Paper*, above n 2.

The CPRS is proposed to commence on 1 July 2011. From 1 July 2011, it is anticipated that businesses covered under the scheme will be required to avoid a 'unit shortfall' by surrendering a suitable number of AEUs or EIEUs[5] to match their annual greenhouse gas emissions where they emit more than 25 000 tonnes of carbon dioxide equivalent ('CO_2e') per year (subject to certain exceptions) or where they are designated as 'proxies' for downstream emitters (for example, where upstream fuel suppliers act as 'proxies' for the emissions of the users of their products, such as vehicle fuel use). A party covered by the scheme that does not surrender sufficient emissions permits to cover its emissions will incur a penalty and potentially a 'make good' obligation.[6] A liable entity may acquire emissions units either at auction or on the secondary market (explained in more detail in Part D below).

B *Liability under the CPRS*

The CPRS will be a 'cap-and-trade' emissions trading scheme under which the federal government will set a cap or limit on Australia's greenhouse gas emissions for each compliance year. It will make available emissions permits approximately equal to the number of tonnes of CO_2e of the cap minus the estimated emissions from sectors not covered by the CPRS. The first compliance year for the CPRS is expected to commence on 1 July 2011.

In general, a 'facility'[7] which emits at least 25 000 tonnes of CO_2e into the atmosphere annually will be liable to surrender emissions permits. Such a facility might be a power station, an industrial complex, a mine or a landfill. In certain cases, for anti-avoidance reasons, landfills emitting less than 25 000 tonnes of CO_2e annually may face a liability.

Where such a facility is under the 'operational control'[8] of a corporation, the liability will attach to the relevant 'controlling corporation'[9] of that corporation, in line with liability for reporting under the *National Greenhouse and Energy Reporting Act 2007* (Cth) ('NGER Act'). This means that it will not be the company which has operational control of the facility that will be liable under the CPRS, but the ultimate Australian holding company of that company.

In cases where there are substantial overall emissions from many small users, it would be impractical to make those users directly liable for those emissions. An example is the emissions from the consumption of fossil fuels for transport.

5 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 132.

6 Carbon Pollution Reduction Scheme Bill 2009 (Cth) ss 133–5, 142.

7 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 5; *National Greenhouse and Energy Reporting Act 2007* (Cth) s 9.

8 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 5; *National Greenhouse and Energy Reporting Act 2007* (Cth) s 11.

9 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 5; *National Greenhouse and Energy Reporting Act 2007* (Cth) s 7. The 'controlling corporation' is essentially the ultimate Australian holding company of the entity that has 'operational control' of the 'facility': at s 7.

In such cases, liability will be placed at a more convenient point 'upstream' in the supply chain (for example, on importers and producers of fossil fuels) with the expectation that the costs of acquiring and surrendering AEUs and EIEUs will be 'passed through' down the supply chain to consumers of the fuel.

In the case of these upstream or 'proxy' liable entities, there is no lower threshold for liability. There is also no involvement of controlling corporations — the entity itself which sits at the appropriate point in the supply chain will bear the liability.

Any entity which will have a liability under the CPRS will have a corresponding liability to report on CPRS-relevant matters under the NGER Act.

The requirement to acquire and surrender sufficient permits to avoid a *unit shortfall* will impose a 'carbon price' on emissions of greenhouse gases.

C *Shifting the Normal Point of Liability*

The CPRS Bills contemplate two mechanisms which may shift the normal point of liability described above:

1. In the case of direct emitters, an LTC will allow, in certain cases, liability under the CPRS to be placed on an entity within a corporate group rather than on the controlling corporation, or on an entity outside the corporate group which has 'financial control' of the emitting facility. It is designed to assist the operation of carbon cost pass-through provisions in contracts, by ensuring congruency between the contracting entity and the entity which incurs such costs; and
2. In the case of upstream fuels for which a 'proxy' near the beginning of the supply chain would normally be liable, an OTN may (in some cases) and must (in other cases) be quoted with the result that liability shifts down the supply chain to the entity which quotes the OTN.

The LTC mechanism is aimed to ensure that carbon costs will be borne by a contracting party (which may not be a controlling corporation that would otherwise be liable for those costs). The OTN mechanism will be particularly relevant for large users and large intermediate suppliers of fossil fuels because it will allow or require such entities to manage their own obligations under the CPRS rather than merely pay an increased price for fossil fuel inputs which incorporates the costs of an upstream supplier's compliance with those obligations.

D *Carbon Pricing*

The cost incurred in acquiring AEUs and EIEUs ('emissions permits') thus emerges as being of paramount importance to businesses. For the first compliance year (2011–12), the government will not impose a cap on emissions and an unlimited number of emissions permits will be available for purchase from the CPRS regulator for a fixed fee of A$10 per tonne. These fixed-price emissions

permits will only be able to be used in relation to the 2011–12 compliance year. For a further four years, an unlimited number of fixed-price emissions permits will be available at a price indexed from a notional A$40 in 2011–12.[10] These fixed-price emissions permits will be able to be used only in relation to their relevant compliance year.[11] In addition, after the first compliance year, the government will conduct a monthly auction of the majority of emissions permits.[12] Permits which are bought at auction will be able to be used for their 'vintage' year (that is, for the first year in relation to which they can be used) and every subsequent year — that is, they can be 'banked'.[13]

Other sources of emissions permits that can be used for compliance under the CPRS will be:

- Australian emissions permits bought on the secondary market;[14]
- certain international emissions units,[15] such as Certified Emissions Reductions under the Clean Development Mechanism of the Kyoto Protocol; and
- freely allocated permits (made available under the emissions-intensive trade-exposed assistance program,[16] under the program for assistance to the coal-fired electricity generation sector,[17] for carbon sequestration due to eligible reforestation projects,[18] and for the destruction of synthetic greenhouse gases).[19]

The object of the CPRS Bills is to achieve a reduction in Australia's greenhouse gas emissions of between five per cent and 25 per cent relative to 2000 levels by 2020. It is likely that, in each compliance year starting from 1 July 2012, an increasingly stringent cap will be in place and therefore a decreasing number of emissions permits will be available to the market. This in turn is predicted to increase the price of emissions permits.

A failure to avoid a unit shortfall may result in two-fold penalties on the liable entities and 'executive officers of bodies corporate' personally.[20] In addition to the administrative penalty, the obligation to surrender permits to meet any unit shortfall will continue under a 'make-good' requirement, with 'make-good' permits equivalent to the shortfall to be surrendered in the next compliance period.

The civil penalty provisions of the CPRS Bill include the failure to quote an OTN when so required, quotation of a false OTN, and failure to make certain required

10 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 89.
11 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 89(5).
12 Explanatory Memorandum, Carbon Pollution Reduction Scheme Bill 2009 (Cth) [3.21].
13 Ibid [8.38]; Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 129(4).
14 Carbon Pollution Reduction Scheme Bill 2009 (Cth) ss 100, 101.
15 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 5.
16 Carbon Pollution Reduction Scheme Bill 2009 (Cth) ss 88, 167.
17 Carbon Pollution Reduction Scheme Bill 2009 (Cth) ss 88, 176.
18 Carbon Pollution Reduction Scheme Bill 2009 (Cth) ss 88, 191.
19 Carbon Pollution Reduction Scheme Bill 2009 (Cth) ss 88, 245.
20 Carbon Pollution Reduction Scheme Bill 2009 (Cth) pt 20.

notifications. Notably, however, the administrative penalty in relation to failure to avoid a unit shortfall is not a civil penalty provision.

Evidently, the obligations under the CPRS will impose a burden on liable entities and relevant officers. Furthermore, the magnitude of the burden is uncertain, as the cost of emissions permits in the long-term is not fixed. Though the impacts on businesses vary, the common denominator is a desire by businesses to reduce such compliance costs through maximum cost recovery and to rid themselves of uncertainty and risk. One of the most effective ways to achieve these outcomes is to simply transfer the carbon cost to another party.

III STATUTORY MECHANISMS

This section outlines the key issues for carbon cost pass-through under each of the statutory mechanisms under the CPRS.

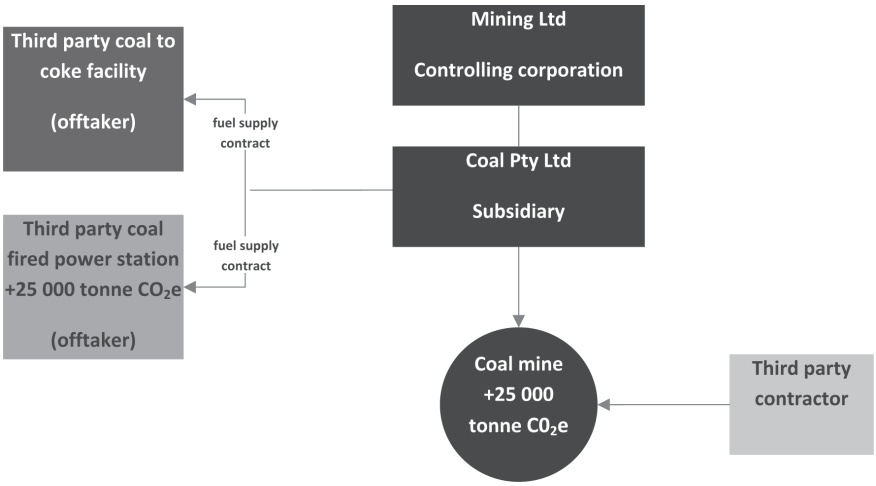
A *Liability Transfer Certificates ('LTCs')*

There are two types of LTC pass-through mechanisms:

- intra-group (Category A) LTCs permit CPRS liability to be passed from a controlling corporation to a member of its corporate group; and
- financial controller (Category B) LTCs permit CPRS liability to be passed from a liable entity for a facility to an external entity where the external entity has 'financial control' of that facility.

Both of these LTC mechanisms are assessed below. The following diagram will be used as a worked example for the rest of this section.

Diagram 1



1 *Category A Transfer*

The Category A LTC is designed to assist the operation of carbon cost pass-through provisions in contracts by ensuring that carbon liability, and the costs associated with this liability, can be borne by the contracting party to supply contracts (which may not be a controlling corporation that would otherwise be liable to surrender emissions permits under the CPRS). The key policy objective of the Category A LTC mechanism is to address the circumstances where placing scheme obligations on the controlling corporation would significantly impair the ability of the controlling corporation, or a member of its group, to pass through carbon costs in existing contracts and convey efficient price signals to end users.[21]

Category A LTC transfers permit CPRS liability to be passed from a controlling corporation to a member of its corporate group upon the satisfaction of the following criteria:[22]

- the company to which liability is proposed to be transferred must be a member of a controlling corporation's group;
- the company to which liability is proposed to be transferred is registered as a company under Part 2A.2 of the *Corporations Act 2001* (Cth); and
- the facility is under the operational control of a member of the group (other than the controlling corporation).[23]

The entity that wishes to assume liability is the entity that must apply to the Australia Climate Change Regulatory Authority ('ACCRA') for the LTC.[24]

This mechanism is most likely to be invoked where a subsidiary, and not the controlling corporation, is the counterparty to a contract for the supply of products or services from the facility, and the contract provides a mechanism for the counterparty to pass through its carbon costs to the purchaser in relation to that supply.

As can be seen in Diagram 1, if Coal Pty Ltd (the subsidiary) has operational control of the coal mine, then Mining Ltd, as the controlling corporation in relation to Coal Pty Ltd, is the entity which is liable to surrender emissions permits in relation to the coal mine under the CPRS. The problem for Coal Pty Ltd is that its fuel supply contract only allows it, not Mining Ltd, to pass through its carbon costs to the 'offtakers'. Therefore, any carbon pass-through mechanism in relation to the supply of output from the facility will not be triggered because Mining Ltd, as the entity who is liable under the CPRS to avoid the unit shortfall by surrendering emissions permits, is not a party to the contract.

21 Explanatory Memorandum, above n 12, [1.254].

22 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 69.

23 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 5; *National Greenhouse and Energy Reporting Act 2007* (Cth) s 11.

24 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 70(2).

However, if Coal Pty Ltd obtains an LTC then it will become the liable entity in relation to the coal mine and, depending on the terms of the fuel supply contract, may be able to pass through the carbon costs to the purchaser.

Where the LTC mechanism is used (either Category A or B), it is essential to recognise the nature of the pass-through clause in assessing its effectiveness. For example, ordinarily, 'change in law' clauses allow the pass-through of costs which occur 'as a result' of a change in law. There is some argument that a distinction should be made between an entity having additional costs imposed on it 'as a result' of a change in law and a voluntary decision to apply for an LTC. It has been suggested that the latter may not satisfy the change in law requirement in such circumstances. This implies that even where an LTC is used, it may be necessary to draft pass-through clauses such that they explicitly allow the pass-through of costs voluntarily assumed.

In an existing contract for a subsidiary, where no LTC mechanisms exist, it is important to assess whether the terms of the contract adequately capture the costs incurred by, and liabilities imposed on, not only the contracting party but also any of its related bodies corporate including, in particular, its controlling corporation.

2 *Category B Transfer*

Category B LTCs apply where an external entity has 'financial control' of a facility. In general terms, financial control exists where an entity has the ability to control the trading or financial relationships of the entity which has operational control over a facility, or where an entity has the economic benefits from the facility.[25]

The key policy reason for a Category B LTC mechanism is that the entity that has financial control over the output of the facility may also have influence over emissions arising from the facility itself, as it controls, for example, the output required to meet contracted 'offtake' arrangements. This is often the case in contract mining scenarios.

As can be seen in Diagram 1, if the third party contractor has operational control of the coal mine, it (as a controlling corporation itself) is liable under the CPRS in relation to the coal mine. If Coal Pty Ltd, as financial controller, wishes to assume liability for the coal mine's emissions, it can apply to ACCRA for an LTC in relation to the coal mine.

There remain, however, several challenges to realising the objectives that CPRS liability vest in the entity best placed to bear them. Though it is recognised that there are other commercial pressures on an entity to assume liability in relation to an asset, there remains a pragmatic issue as to whether an entity would take it upon itself to incur additional costs such as CPRS liability, even if it is the entity best placed to do so. Nor does the CRPS Bill provide any guidance as to which

25 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 81.

entity should assume liability where more than one entity fits the definition of having financial control, for example in certain unincorporated joint ventures.

A further barrier to the efficient allocation of CPRS liability that is common to both the Categories A and B LTC is that voluntary assumption of CPRS liability could amount to a breach of directors' duties in some situations. Section 181(1) of the *Corporations Act 2001* (Cth) stipulates that a director has the duty to act in good faith in the best interests of the company and for a proper purpose. Whether directors will fall foul of this duty by overseeing the voluntary assumption of CPRS liability for their company will depend on the circumstances of each individual transaction. It is also unclear whether the final CPRS Bill will address this issue.

Problems could also arise where there is a contractual obligation on the LTC holder (for example, in its contract with an offtaker) to avoid or mitigate a 'change' event, as defined contractually, where a change in law clause or impost mechanism exists in the contract (these concepts are discussed at Part IV). It could be argued that assuming liability by virtue of an LTC would breach a requirement by the LTC holder to avoid incurring imposts. Therefore, the entity which wishes to assume liability under an LTC should consider whether any downstream contracts contain obligations that may be breached as a result of the voluntary assumption of CPRS liability.

B *Obligation Transfer Numbers ('OTN')*

The OTN scheme is designed to manage CPRS obligations between upstream fuel suppliers and direct emitters, and avoid double-counting of emissions. An OTN is an administrative mechanism that enables the government to track fuel as it moves from the top of the supply chain to direct emitters. The OTN scheme also recognises fuel sold from one fuel supplier to another.

The scheme aims to ensure the efficient pass on of compliance costs through the supply chain to parties who are incentivised to obtain permits at the lowest cost possible.[26] It permits the responsibility for CPRS compliance to be shifted from fuel suppliers to large fuel users in some circumstances, and provides a framework for suppliers to be able to distinguish between fuel supplied to large users who have their own obligations, and other users for whom the supplier retains the obligation to comply with the CPRS.

The use of an OTN can be mandatory or voluntary.[27] One of the distinct differences is that a mandatory quotation must be in writing, while a voluntary quotation need not. In addition, a 'large fuel user' is defined differently in relation to mandatory and voluntary OTN use. For voluntary OTN use, a large fuel user will be defined by the regulations. The government's intention is to define the

26 Explanatory Memorandum, above n 12, [1.26].

27 For mandatory quotations of OTNs, see Carbon Pollution Reduction Scheme Bill 2009 (Cth) pt 3 div 5 sub-div C. For voluntary quotations of OTNs, see Carbon Pollution Reduction Scheme Bill 2009 (Cth) pt 3 div 5 sub-div D.

threshold as 25 000 tonnes of $CO2_e$ or less.[28] This will enable fuel users required to quote an OTN for a single fuel source to voluntarily quote an OTN for their other fuel sources.[29]

Some entities which are permitted, but not required, to obtain their fuel with an OTN to directly manage their permit liabilities include large fuel users covered by the scheme including liquid petroleum fuels, entities using the fuel as feedstock to manufacture a product or consume the fuel otherwise than by way of combustion and entities transforming the fuel into another type of eligible upstream fuel.[30] Voluntary quotations must be initiated by the purchaser, and can be rejected by the supplier.[31]

Conversely, entities which *must* quote an OTN in writing when obtaining their fuel include large fuel users (other than petroleum liquid fuel users) which operate a facility that has emitted more than 25 000 tonnes of CO_2e of a single fuel source in a given financial year, re-suppliers of natural gas and feedstock users of liquid petroleum gas. For such entities, a failure to quote an OTN is an offence.[32]

Specifically, the OTN scheme only covers certain fuel (known in the CPRS Bill as 'eligible upstream fuel'). This includes liquid petroleum fuel, liquid petroleum gas, black coal, brown coal, coking coal, brown coal briquettes, coke oven coke, coal-based char, natural gas that is distributed or transmitted in a pipeline, coal seam methane that is captured for combustion, coal mine waste gas that is captured for combustion, ethane, town gas, liquefied natural gas, compressed natural gas, syngas and refinery grade propene.[33]

Where certain fuel users quote an OTN, the supplier is relieved of its obligations under the CPRS. These obligations fall instead on the fuel purchaser. An OTN may be quoted for a 'one-off' transaction or a 'standing quotation' may be used for ongoing business.[34]

The OTN mechanism will be particularly relevant for large users and large intermediate suppliers of fossil fuels, because it will allow, or require, such entities to manage their own obligations under the CPRS rather than merely pay for fossil fuel inputs an increased price which incorporates the costs of an upstream supplier's compliance with those obligations.

28 Explanatory Memorandum, above n 12, [1.233].

29 Ibid [1.231].

30 Carbon Pollution Reduction Scheme Bill 2009 (Cth) pt 3 div 5 sub-div D.

31 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 66.

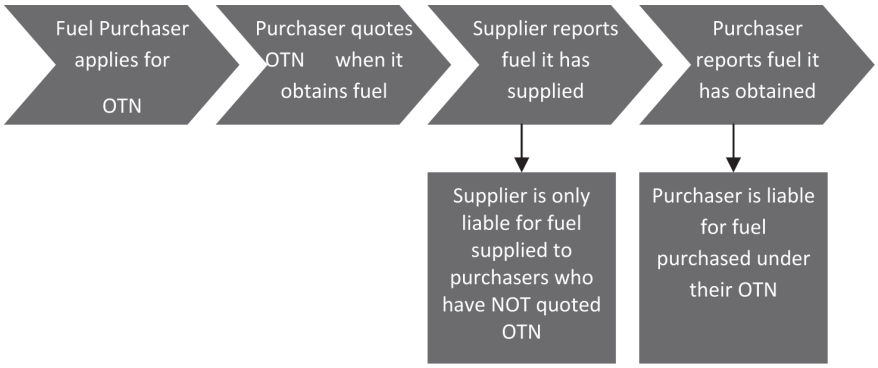
32 Carbon Pollution Reduction Scheme Bill 2009 (Cth) pt 3 div 5 sub-div C.

33 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 5.

34 Carbon Pollution Reduction Scheme Bill 2009 (Cth) pt 3 div 5 sub-div B.

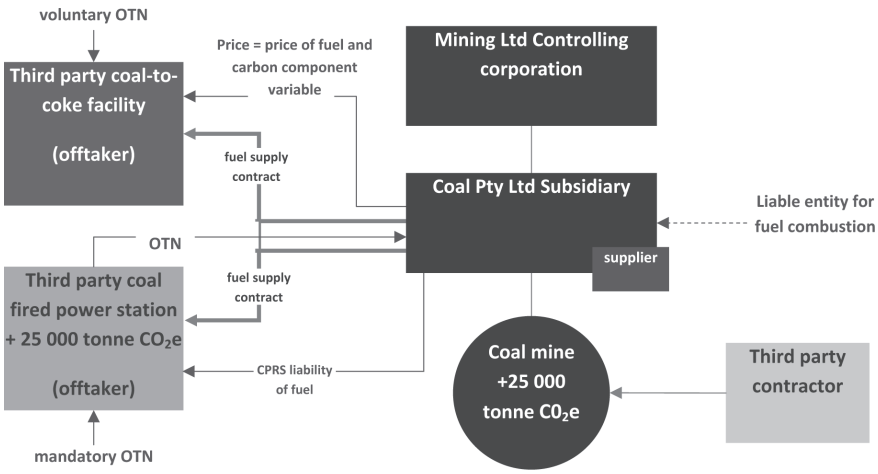
Diagram 2 explains how this works:

Diagram 2



The following is an example of how mandatory and voluntary quotations operate in practice:

Diagram 3



In the scenario in Diagram 3, to isolate and analyse OTN matters, assume that Coal Pty Ltd Subsidiary is the liable entity under the CPRS for the combustion of fuel which it supplies. Coal Pty Ltd supplies coal to the third party coal-to-coke facility, and the third party coal fired power station.

The power station emits more than 25 000 tonnes of $CO2_e$ in relation to the combustion of fuel supplied under the contract. Consequently, under the CPRS Bill the power station must mandatorily quote an OTN.[35] The effect of the OTN is that the coal offtaker and operator of the power station, and not Coal Pty Ltd, will be liable under the CPRS for emissions in respect of that fuel.

35 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 52.

By contrast, the coal-to-coke facility is not obliged to quote an OTN, but may do so voluntarily. This is because it is not a large fuel user (+25 000 tonnes $CO2_e$) and the CPRS Bill provides that supply of coal to this entity allows for use of a voluntary OTN.[36] Should the coal-to-coke facility choose to quote a voluntary OTN, it assumes CPRS liability for emissions relating to the fuel supplied by Coal Pty Ltd. Conversely, if the coal-to-coke facility decides not to quote an OTN, Coal Pty Ltd will be liable for the downstream combustion of emissions in relation to that fuel supply under the CPRS, in which case Coal Pty Ltd will seek to adjust its fuel price to include the additional carbon costs incurred under the CPRS. The terms of the fuel supply contract will govern such price adjustment.

Supply arrangements undertaken by use of an OTN should include back up provisions for price adjustment (for carbon cost excluded prices) where OTN use ceases to apply to that contract.

An issue with the OTN scheme arises, however, as it potentially permits upstream entities to pass their costs down the supply chain, finally accumulating in a cost to be passed on to the end consumer. In Diagram 3, assume Coal Pty Ltd purchases fuel (eg diesel) to run the coal mine. As between the upstream fuel supplier and Coal Pty Ltd, Coal Pty Ltd Subsidiary may choose to or may have to quote an OTN. Either way, this results in Coal Pty Ltd incurring the liability, and hence direct cost in relation to that fuel, under the CPRS. This now constitutes a direct cost for Coal Pty Ltd and is most likely to be passed through to the coal-to-coke facility and the coal fired power station under the fuel supply contracts. On the contrary, if no OTN was quoted or required to be quoted, the fuel will be supplied to Coal Pty Ltd at a cost which includes a carbon cost component. As this additional cost to Coal Pty Ltd would be characterised as an indirect cost, it would be less likely that such costs can be passed through to the offtaker under the fuel supply contract, as indirect costs are generally more difficult to pass through (unless explicitly provided for). This is of particular concern where a long supply chain exists.

The options and issues for contractually passing on direct and indirect carbon costs are considered below.

IV CONTRACTUAL MECHANISMS

The limited scope of the LTC and OTN schemes emphasises the importance of contractual mechanisms to pass through carbon costs to customers and offtakers.

If a company is entering into a new contract or has a contract coming up for review and renegotiation, careful consideration should be given to including a carbon price adjustment mechanism which allows the supplier to pass through its costs under the CPRS to the customer or offtaker. It is important that such clauses are carefully drafted to ensure that the proposed CPRS is addressed, yet allows

36 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 56.

flexibility if the scheme design were to be changed or replaced by the federal government (or, indeed, the relevant state or territory government) by another greenhouse gas reduction law (such as a carbon tax).

Where the company has existing contracts, it is prudent to undertake a due diligence type review of the price adjustment mechanism in each contract, where applicable, to assess whether direct or indirect costs can be passed through to each other party to the agreement.

In doing so, there are a few issues which must be at the forefront of consideration. As discussed above, the threshold question is to identify who the liable entity is under the CPRS. Notwithstanding the use of the LTC or OTN schemes, liability under the CPRS for acquiring emissions permits will generally fall on the controlling corporation in a corporate group.[37] It is therefore important in contracts where the supplier is a subsidiary of a controlling corporation to ensure the carbon pass through clause in the contract captures the costs incurred by, and liabilities imposed on, not only the contracting party but also any of its related bodies corporate including, particularly, its controlling corporation.

Furthermore, the ambit of carbon pass through clauses needs to contemplate that obligations under the CPRS can be relieved by the purchase of emissions permits from a number of sources, including:

- a pool or scheme;
- Australia or abroad; or
- a public or private source.[38]

Pass through provisions should also include a rise and fall mechanism in relation to carbon costs so as to take into account both increases and decreases in carbon costs incurred by the supplier or its controlling corporation.

Notably, the three main contractual mechanisms which can be employed to pass through carbon costs incurred under the CPRS are:

- carbon costs provisions;
- imposts provisions; and
- change of law provisions.

They each present various issues as discussed below.

A *Carbon Costs Provisions*

Carbon costs provisions in contracts are expressly designed to allow the pass through of carbon costs by the party that incurs those costs.

37 Carbon Pollution Reduction Scheme Bill 2009 (Cth) s 17.

38 Carbon Pollution Reduction Scheme Bill 2009 (Cth) pt 4.

Typically, carbon costs provisions operate by stipulating that carbon costs incurred in compliance with the CPRS will be included in the contract price. Owing to the uncertainty of what form the final CPRS will eventually take, the wording in carbon costs provisions is vital — it must be sufficiently specific yet broad enough to prove its effectiveness when invoked. Of particular importance are terms such as 'emissions units', 'emissions trading legislation' and 'carbon costs' (or equivalent).

For example, while expressly providing for the kinds of permits that will be able to be surrendered under the CPRS and the range of strategies which will be available to a party acquiring emissions permits, the following proposed definition of an emissions permit also leaves room for flexibility if a different emissions trading scheme design is adopted. This is achieved through the use of the terms in bold:

> a **permit**, **authorisation**, **licence**, **allowance** or **consent** (**however named and however acquired**) which enables its holder to **emit** into the atmosphere a specified quantity or intensity of greenhouse gases without incurring a **liability for a financial or other penalty** pursuant to the **Emissions Trading Legislation**.

The breadth of carbon costs provisions ensures their application under most conceivable circumstances. Often, they recognise that carbon costs are not static and permit the pass through of reasonable costs incurred. Simultaneously, the specificity of the clauses in regards to some form of carbon cost evinces a clear intention between the contracting parties to effect the pass through of carbon costs.

However, the level of detail and prescriptiveness within carbon costs provisions tends to vary greatly. Generally, the more prescriptive and detailed a clause is, the less potential for confusion and disputes. Such added advantages can be effectively realised through coverage of a number of key aspects of a carbon cost regime, including:

- a method of calculation of carbon costs;
- prescriptive definitions of which costs can be recovered (direct and/or upstream carbon costs);
- a payment claim regime;
- clear expression regarding who can bear the cost (eg related bodies corporate);
- a price adjustment clause which sets out the mechanics and clearly enables these defined costs to be attributed and passed through under the agreement;
- if you are acting for the customer, a clause excluding the pass through of penalties arising to non-compliance with the emissions trading scheme; and
- a dispute resolution regime.

These mechanisms aim to create clarity and minimise disputes as to the quantum and payment of costs.

On the other hand, a less prescriptive carbon costs provision has the advantage that it is simpler, is more akin to conventional price-adjustment provisions, and is more likely to feel familiar to the client's commercial negotiators. These factors affect how acceptable the terms are to counterparties.

B *Imposts Provisions*

Generally, imposts provisions provide for payment arrangements should 'imposts' be imposed on the supplier during the term of the contract. Therefore, it is conceivable that the imposts provisions in some agreements may suffice in allowing the pass through of the supplier's carbon costs. Crucially, for such provisions to apply to carbon costs, the carbon costs must constitute an 'impost'. The key factor influencing this is whether 'impost' is defined or undefined in the relevant contract.

In the case where the term is left undefined, 'imposts' is generally taken to be 'a tax, tribute, or duty' or an 'imposition', which in turn means 'the laying on of something as a burden, obligation' or 'something imposed, as a burden, levy, tax'.[39] This is a broad definition.

Furthermore, the term 'impost' was considered by the New South Wales Court of Appeal in *Baulkham Hills Shire Council v Wrights Road Pty Ltd*.[40] The Court concluded that the term 'impost' extended beyond 'a compulsory extraction of money in the nature of a tax', as found at first instance in that case,[41] to instead include:

> a requirement to make a payment for a public purpose imposed, pursuant to a statutory authority expressly providing for monetary payment, as a condition for the exercise of a statutory power.[42]

Hence, a likely interpretation is that unless otherwise defined, the obligation to avoid a shortfall under the CPRS by acquiring and surrendering emissions units can be characterised as an 'impost'. Avoiding a unit shortfall can also be viewed as an imposition to incur costs as a result of the acquisition of permits.

Where 'impost' is defined, the ability to pass through carbon costs will turn considerably on the precise wording of the definition. A typical definition is as follows:

> Impost means any tax (other than income tax or capital gains tax), excise, charge, levy, duty, fee, rate, royalty (whether based on value, profit or otherwise) or impost levied, charged or imposed on Service Provider by any level of any government, any government agency or any other body authorised by law which is imposed on or applied to the Pipeline (or any of

39 Susan Butler (ed), *The Macquarie Dictionary* (5th ed, 2009).

40 (2007) 153 LGERA 219.

41 *Wrights Road Pty Ltd v Baulkham Hills Shire Council* (2006) 3 DCLR (NSW) 171, 171–2.

42 *Baulkham Hills Shire Council v Wrights Road Pty Ltd* (2007) 153 LGERA 219, 223 (Spigelman CJ).

its components), the operation of the Pipeline or the provision of services by Transporter under this Agreement.

In this example, whether carbon costs can be classified as an impost will depend on how the words 'tax', 'excise', 'charge', 'levy', 'duty', 'fee', 'rate' and 'royalty' are defined. In the absence of definitions in the contract, the ordinary meaning would typically be attributed to the words. In deciding whether carbon costs incurred under the CPRS are within the ambit of these words, it is essential that a technical and precise analysis of the contract is carried out. Considerations to take into account include:

- the negative nature of the obligation under the CPRS to prevent a unit shortfall of the surrender of permits for the amount of emissions, as distinct from a positive obligation;
- whether the definition of impost requires an imposition by a particular party or body;
- which aspects of a carbon cost can be passed through (eg limited to imposts applied to the Pipeline itself, the operation of the Pipeline or the provision of services by the Transporter);
- the overriding principle of construction when interpreting commercial agreements — which is to give effect to the intentions of the contracting parties; and
- the rule of contractual interpretation known as the *ejusdem generis* rule, which provides that where particular words are followed by general words, the general words are limited to the same kind as the particular words.

It should be noted that the above analysis represents only one view and remains subject to case law interpretation as the relevant body of law builds up in the future.

The imposts provisions have the advantage that if a carbon cost imposition is enacted, but of a kind quite different from that contemplated by the CPRS, it may still be effective in allowing the pass through of carbon costs.

On the other hand, imposts provisions are often not carbon cost-specific. This may leave it open to interpretation as to whether carbons costs under the CPRS are precluded from the ambit of the clause as an intention to include them is less obvious (cf a carbon costs provision). In addition, the uncertainty of analysis at this stage is heightened as the interpretation of such clauses as they apply to carbon costs has not been tested in the courts.

C *Change of Law Provisions*

Change of law provisions are the most general of the contractual mechanisms discussed in this paper. They are designed to allow for an adjustment in the contract price as a result of a change of law, including a change of law such as would impose carbon costs on a supplier, or vary the amount of such carbon costs.

It is doubtful whether standard change in law provisions will be able to afford bearers of carbon costs much relief, owing to the complexity of the CPRS. The first hurdle is the definition of 'change in law', as the coverage of carbon costs will depend greatly on this. It is not rare to find change in law provisions precluding such events where details of the change have been announced at the date of the contract.

Another consideration is the select circumstances under which a change in law provision is intended to operate. The original introduction of the CPRS (or any similar scheme) is highly likely to involve a change of law as defined under most agreements. However, the subsequent development of the carbon market and the consequent variations in the price of emissions permits will not necessarily be the result of a change of law as defined.

One way of addressing this difficulty is by providing that a method of calculating the contract price from to time may be proposed upon the occurrence of a change in law. Note, though, that this is a provision which will only be able to be used once — and costs are hence calculated on a once-off basis — unless there is a genuine further change of law (for example, the enactment or promulgation of a more restrictive emissions 'cap') as opposed to the normal development of the carbon market. The change in law provision fails to take into account that carbon costs are not static. This is exacerbated by some change in law provisions limiting the pass through of costs only to direct costs and excluding indirect costs.

On the other hand, an advantage which change of law provisions have is their generality. That generality means that a change of law provision would be able to address a wide range of developments, whether related or not to the issue of carbon costs.

V CONCLUSION

The pass through of a person's costs of complying with the CPRS presents complex legal and commercial issues, some of which the CPRS Bill in its current form does not address. It will be of immense interest when, or rather if, clarification is provided.

The importance of contractual mechanisms is highlighted by the restrictive application of the statutory pass through schemes proposed by the CPRS Bill. Carbon costs may be passed through contractually via a variety of mechanisms, including carbon costs provisions, imposts provisions, and change of law provisions. While each mechanism has its merits and shortcomings, common considerations in contractual pass through provisions include ascertaining that carbon costs, potentially including those of a related body corporate, are able to be passed through, that emissions units can be acquired in a number of ways, the inclusion of a rise and fall mechanism and the rules of contractual interpretation. It is finally noted that stances on such considerations will rely greatly on which party one is acting for.

Although the future of the CPRS is uncertain and the scheme has many uncertainties, it is contended that some form of emissions trading scheme will eventuate in line with Australia's obligations under the Kyoto Protocol. Amidst the unknowns, however, one certainty is that pass through mechanisms will play a pivotal role in business, as obligations imposed by the CPRS or another form of emissions trading system will create significant costs for liable entities.