



Australian Government

Department of the Prime Minister and Cabinet

**ABATEMENT INCENTIVES PRIOR
TO THE COMMENCEMENT OF THE AUSTRALIAN
EMISSIONS TRADING SCHEME**

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PURPOSE

On 17 July 2007, the Government released *Australia's Climate Change Policy: our economy, our environment, our future*, endorsing the key design features of the emissions trading scheme set out in the report of the Prime Ministerial Task Group on Emissions Trading. The Government has indicated that it is aiming for the emissions trading scheme to commence in 2011 and that it is committed to ensuring that incentives for abatement are maintained in the period leading up to scheme commencement. The Government has also committed to consulting extensively with stakeholders on the design of the emissions trading scheme over the coming year, including through the release of discussion papers.

The purpose of this discussion paper is to seek public comment on possible arrangements to give effect to this commitment. This paper does not represent Government policy and does not commit the Australian Government to any particular proposal. Proposals contained in this paper are for discussion only. Discussions with domestic stakeholders and international partners will occur over the coming months, concluding in early December 2007.

Stakeholders are invited to comment on proposed approaches and issues outlined in the paper, particularly the key approaches and questions identified in boxes.

All submissions in response to this discussion paper should be emailed to the Climate Change Group by 1 December 2007 at emissionstrading@pmc.gov.au. Guidelines for submissions are available on the Department of the Prime Minister and Cabinet website under emissions trading (www.pmc.gov.au/climate_change/emissions). Submissions will be made available to the public via this website unless specifically requested otherwise.

Submissions may also be sent to:

Climate Change Group
Department of the Prime Minister and Cabinet
PO Box 6500
CANBERRA ACT 2600

If you have any queries, please contact the Climate Change Group on telephone +61 2 6271 5215.

1 INTRODUCTION

There are two key design issues relating to incentives for firms to pursue abatement in the period leading up to the commencement of emissions trading – ensuring firms do not cease abatement and what might be done to encourage even greater levels of abatement if the Government deems this appropriate.

The first issue necessitates permit allocation rules that ensure firms continue to undertake abatement prior to the commencement of trading and factor future carbon prices into investment decisions. The Government has already given an assurance that firms will not be disadvantaged in their permit allocations as a result of abatement they undertake in the lead up to emissions trading and this paper proposes administrative arrangements to give effect to this commitment.

It is also important that future carbon price scenarios are recognised when making investment decisions. The Prime Minister has announced that compensation for those firms facing disproportionate loss in asset value will apply only to assets in existence on 3 June 2007. This paper seeks feedback on the definition of ‘existing assets’ eligible for compensation under the scheme.

The second issue concerns the provision of incentives to bring forward additional abatement in the lead up to the commencement of trading. In the absence of such incentives, abatement actions that could be taken now, but which may involve additional costs, may be delayed until nearer the commencement of emissions trading. This paper discusses a possible approach to providing credit for new activities that deliver additional abatement in the period prior to the commencement of the scheme. It is important to note, though, that such incentives are not costless – achieving maximum value at least cost will be central to any decision to encourage such additional abatement.

Finally, it is worth noting that while this paper talks about the commencement of trading as the trigger for certain actions under the emissions trading scheme, it is more strictly correct to define the trigger as the commencement of the legal obligation placed on liable parties to acquit permits equal to their emissions. This paper will use the terms interchangeably and, in line with the Government’s intention, will assume 2011 is the trigger date. However, there is no legal prohibition that would prevent interested parties from commencing to trade in permits, early action or credits or derivative products prior to this date¹.

Box 1.1: Key concepts and definitions

Abatement

Abatement refers to a project or activity which removes greenhouse gases (GHG) from the atmosphere or reduces emissions of these gases below what they would otherwise have been. The amount of GHG emitted into the atmosphere fluctuates for a variety of reasons including natural weather events and changes in the production of emissions intensive goods as a result of normal market variations. These fluctuations are reflected in Australia’s annual greenhouse gas inventory but are not regarded as abatement.

It is common to distinguish between ‘business-as-usual’ and ‘additional’ abatement for the purposes of defining offset credits.

¹ An abatement registry will be required to enable effective tracking of secondary trading in carbon commodities – a proposal to establish such a register is outlined below.

Box 1.1: Key concepts and definitions***'Business-as-usual' abatement***

Business-as-usual abatement is that which occurs in the normal course of business, including in response to government regulations. It takes place in the absence of an explicit additional driver or incentive. For example, a decision to undertake commercially viable energy efficiency measures or to close an unprofitable facility may reduce a firm's emissions but these actions would have occurred within a normal business operating framework.

'Additional' abatement

Additional abatement delivers a reduction in the amount of GHG in the atmosphere. It is beyond, or additional to, 'business-as-usual' abatement. For example, where abatement is not commercially viable under existing market conditions this may demonstrate that it goes beyond business-as-usual activities. Examples of additional abatement include investments in technologies that could significantly reduce emissions but are not yet commercially cost effective; energy efficiency savings that involve significant up-front implementation risks and costs; and investments in carbon sink forests.

'Covered' and 'uncovered' sectors

Covered sectors are those which would be included in the emissions trading scheme from the commencement of trading (i.e. 2011) – that is, all activities other than agricultural production, forestry and land use. Emissions from agricultural production, forestry and land use are referred to as 'uncovered' activities because they will not be included within the scheme initially. Abatement of these emissions will be eligible to generate offsets.

While land-based sectors will not be liable for their direct emissions, their indirect emissions from fuel and energy use will be covered 'up-stream' as fuel distributors and power stations will have to hold permits.

Decisions on whether a small number of other sectors, including waste, will be included in the covered or uncovered sectors will be made during the detailed design phase of the emissions trading scheme².

Offset Credits

Offset credits represent abatement. These credits can be used to counterbalance emissions that are covered by the emissions trading scheme. Offset credits can also be purchased by firms, events or individuals wishing to voluntarily reduce or offset their carbon emissions, even if they are not liable parties under the trading scheme.

Offset credits can only be generated by new projects to abate emissions that are not covered by the emissions trading scheme in the first instance. Offsets can not be created in any sector covered by the scheme as these emissions are by definition included in the overall scheme cap. For example, offsets cannot be created from energy efficiency measures or measures to limit use of transport fuels as liability for these emissions will rest with the power generator and the fuel distributor respectively³.

² The Government will consult on coverage issues in early 2008.

³ Accordingly, the agricultural sector can only create offsets from projects involving reductions of agricultural and land use emissions or removals of emissions through biosequestration, and not from avoided energy emissions as these are covered by the scheme.

Box 1.1: Key concepts and definitions***Early action credits***

The term early action credit refers to credits that would be issued for abatement occurring between now and 2011 from activities that will be covered by the emissions trading upon its commencement (covered sectors).

Emissions Permits

Emissions permits represent the right to emit greenhouse gases, measured in terms of tonnes of carbon dioxide equivalent (CO₂e). The Government will establish a cap for the emissions trading scheme in terms of the net amount (in tonnes) of CO₂e that can be released into the atmosphere, and then auction or freely allocate up to the same number of emissions permits. Liable parties will need to hold permits or offset credits to cover all their emissions. Over time, the number of permits on issue will fall as Australia's national emissions cap reduces. Consequently, future permits will become scarcer and their cost is expected to increase, thereby generating a rising forward price for permits.

Voluntary carbon market

Many companies, governments and private individuals are choosing to voluntarily buy abatement – normally in the form of carbon offset credits - in order to reduce or completely offset their carbon emissions, for example, in order to market 'carbon neutral' products, events or services. This is referred to as the voluntary carbon market. By contrast, participants in the emissions trading scheme will be legally obliged to acquit permits or offset credits to cover their emissions – it will be a matter for each firm as to whether it chose to reduce its emissions to match any permits it may have freely received, or to purchase permits or offset credits in the market or at auction. Voluntary demand for offsets is likely to remain a feature of the carbon market even after formal commencement of the emissions trading scheme.

2 ENSURING ALLOCATION RULES MAINTAIN ABATEMENT INCENTIVES

Australian firms have already undertaken significant abatement. However, there is a risk that further abatement may be delayed if firms are uncertain about permit allocation rules, particularly how their own emissions may impact on future decisions as to whether, and to what extent, they are eligible to receive a free allocation of permits.

Under the emissions trading scheme permits will be allocated to avoid prejudicing the competitiveness of trade-exposed, emissions-intensive (TEEI) firms and to provide once and for all compensation to firms facing a disproportionate loss in asset value as a result of the introduction of an explicit emissions constraint (see **Box 2.1**).

Box 2.1: Free permit allocation under the Australian Emissions Trading Scheme

The Government has agreed to provide an up-front, once and for all, free allocation of permits to firms suffering a disproportionate (that is, significantly larger than average) loss of asset value as a result of the introduction of an aggregate constraint on Australia's emissions. The Government has also agreed that trade exposed, emissions intensive firms will be subject to transitional arrangements whereby they receive free permits while their international competitors do not face a comparable carbon constraint to that in Australia.

2.1 'No disadvantage' arrangements

On 3 June 2007, when announcing the Government would introduce emissions trading, the Prime Minister stated that "firms which undertake abatement between now and the start of emissions trading will not be disadvantaged."⁴ No disadvantage arrangements therefore apply to abatement action undertaken after this date. The arrangements include abatement activities and investments in low emissions technology development in relation to existing assets⁵. This will ensure that firms are not adversely affected in their permit allocations, irrespective of whether they are eligible for compensation for disproportionate loss or subject to the transitional arrangements for TEEI firms.

The best way to ensure firms are not disadvantaged for undertaking new abatement prior to 2011 is to use entity emissions data for the period prior to the announcement of the intention to adopt emissions trading as part of the information base for allocation. Unfortunately, verified emissions data will not be available for many firms until after the first mandatory reporting period under the new National Greenhouse and Energy Reporting System (NGERS).

The NGERS will require firms within the reporting thresholds to report facility and corporate level emissions data beginning with the 2008-09 financial year. The reporting system will also allow firms voluntarily to report emissions and any abatement (whether business-as-usual or otherwise) undertaken prior to this time.

It is proposed that the scheme regulator would use entity emissions data reported in 2008-09 as well as verified abatement data from 2007-08. In effect, this would provide the regulator with validated data from the announcement of the scheme⁶. Abatement, including 2007-08 actions, can be reported through NGERS from mid 2008, along with emissions and energy data, and will need to

⁴ Address to the Liberal Party Federal Council, 3 June 2007

⁵ This would include, for example, investments undertaken as part of the LETDF or other government technology programs.

⁶ 1 July being sufficiently close to the 3 June 2007 announcement date to be unlikely to have affected firm behaviour in the intervening period.

meet the same measurement, monitoring and verification standards. In the meantime firms will need to maintain detailed records of 2007-08 abatement activities⁷.

The manner in which emissions data will be factored into the calculation of permit allocations – and the many other factors that may affect these calculations – will depend on final decisions about the precise allocation methods and whether or not firms are classified as TEEI or considered likely to suffer disproportionate loss. Permit allocation will be the subject of extensive consultation in 2008. The particular issues surrounding the treatment of new TEEIs will be a priority for consultation in early 2008.

Generally, firms that will be covered by the scheme are likely to focus on reducing emissions in preparation for the commencement of permit trading. Nevertheless, it is proposed that the scheme regulator have the capacity to refer to other sources of emissions data if, for example, reported emissions appear abnormally high. Access to additional sources of data would assist the regulator to ensure permit allocations are as equitable and appropriate as possible, including by safeguarding the scheme from incentives to inflate 2008-09 data. Stakeholder advice is sought on relevant sources of data that could be used for this purpose (eg, information from environmental approval processes or other greenhouse and energy use programmes).

Issues for stakeholder consideration

It is proposed that the emissions trading scheme regulator use verified emissions data from the first mandatory reporting period under the National Greenhouse and Energy Reporting System as an input into permit allocations.

It is proposed that the regulator supplement this with verified abatement data from the previous year and draw on other relevant sources of data where this would assist in ensuring firms receive an appropriate allocation of permits.

Firms are encouraged to report abatement through the National Greenhouse and Energy Reporting System along with other corporate emissions and energy data, and to keep high quality records of abatement activity in the mean time.

Stakeholder advice is sought on relevant sources of data outside of NGERs that could be used for this purpose (eg, information from environmental approval processes or greenhouse or energy use programmes such as Energy Efficiency Opportunities).

2.2 Assets eligible for compensation

As noted above, the Prime Minister has confirmed that only assets in existence as at 3 June 2007 would be eligible for consideration under the Government's proposed compensation arrangements. This will ensure that investors factor in potential carbon prices when considering new investments between now and the commencement of trading.

In most cases, an asset's existence is unambiguous. However, for new assets, eligibility criteria are necessary to determine whether the construction of, or the commitment to the construction of an asset, had become unavoidable as at 3 June 2007.

⁷ The Australian Greenhouse Office (AGO) Greenhouse Challenge Plus (GCP) Reporting Guidelines and GCP Independent Verification Guidelines, which are based on the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard (revised edition), provide advice on record keeping. The AGO Factors and Methods Workbook provides technical detail relating to determining greenhouse gas emissions. Both are available through the Australian Greenhouse Office website www.greenhouse.gov.au.

The Government proposes to follow the guidance afforded by the definition of a ‘committed asset’ within the national electricity market, and seeks comment on what best constitutes comparable definitions for other sectors. **Appendix A** considers these issues in more detail.

As a matter of principle, assets that may be taken to be ‘in existence’ at the cut-off date would be currently productive assets or assets that companies have irreversibly committed to acquiring or constructing. This principle will apply to all industries that may be eligible for consideration under the Government’s proposed compensation arrangements.

Issues for stakeholder consideration

Stakeholder feedback is being sought in relation to the definition of an asset “in existence” at the cut-off date.

Feedback is sought in relation to the guidance afforded by the use of the National Electricity Market (NEM) definition and criteria for the electricity generation sector, and any necessary amendments to the criteria that may be necessary to give a similar outcome for other industries.

3 POSITIVE INCENTIVES TO UNDERTAKE ADDITIONAL ABATEMENT

Maximising abatement incentives in the lead up to the formal commencement of emissions trading will assist companies to reduce future obligations and build capacity to manage both their emissions and future carbon price risks. This can help smooth the transition to trading by encouraging take up of low cost abatement opportunities and early carbon price discovery. Providing incentives to encourage firms to maintain their abatement efforts will also help Australia meet its Kyoto Protocol target⁸.

Any attempt to achieve additional abatement will carry with it a fiscal cost. This occurs either because actual dollars are used to purchase additional emissions reductions or because future revenue – the capacity to auction a permit – is forgone with the provision of credits in exchange for abatement⁹. Accordingly, it is important that the extent and form of any credit for additional early action represent value for money.

The Government is inclined to provide incentives for firms to continue to undertake abatement in the lead up to 2011, provided this can be done simply and without compromising the integrity of the trading scheme. The following proposals represent an approach to encouraging this abatement. However, stakeholders should note that no firm decisions have been taken by Government on these approaches.

3.1 *Standards for abatement recognised by the scheme*

The Government has committed to the development of robust and transparent standards for accrediting offsets for use in the emissions trading scheme.

The additionality of offsets is a key element of the scheme. If offsets are not additional, liable parties could in effect be paying firms outside the scheme, that do not have an emissions liability, to undertake activities that are already cost effective or that they would have undertaken anyway, including in response to government regulation or incentives. This would be inequitable. It would also undermine the environmental integrity of the emissions trading scheme. To meet internationally recognised standards for environmental integrity, offsets should represent abatement that is additional, has actually occurred, and is permanent¹⁰, measurable, and verifiable.

The same principles need to apply to any activities for which early abatement credits are provided for future recognition in the emissions trading scheme. Such abatement needs to be qualitatively equivalent to emissions permits to the maximum extent possible – that is, both must represent an equivalent amount of greenhouse gases – as they will be used interchangeably once recognised within the emissions trading scheme. This principle is critical to ensuring an Australian emissions trading scheme can link with other schemes, with the benefits this provides in terms of building towards a workable global emissions trading scheme and providing access to lowest cost abatement opportunities.

⁸ Note that abatement undertaken in the period 2007-2011 that is applied to offset emissions within the trading scheme after 2011 does not represent a double count – it will only be counted once, as it occurs, in Australia's national inventory of greenhouse gas emissions, which record actual annual emissions.

⁹ The provision of credits in this manner is analogous to tax expenditure.

¹⁰ That is, abatement is not reversed by subsequent developments, and hence represents a permanent reduction in CO₂ equivalents in the atmosphere.

Issues for stakeholder consideration

It is proposed that credits only be provided for activities that represent abatement that has actually occurred, is additional, permanent, measurable, and verifiable.

3.2 Eligible activities

In considering abatement incentives it is necessary to distinguish between covered sectors and uncovered sectors for two reasons: firstly, because firms in covered sectors in many cases already have strong incentives to reduce their emissions in preparation for the start of trading; and, second, because only sectors outside the scheme (that is, those without a liability to acquit permits under the scheme) will be able to create offsets after 2011.

Once trading commences, abatement from sectors within the scheme will reduce the emissions of participants and hence reduce the number of permits they are required to acquit each year. Continuing to credit pre-2011 abatement activities by these firms once the scheme commences would therefore result in abatement being counted twice, first to create the carbon offset both prior to and after the start of the scheme, and second to reduce the emissions liability faced by the firm once trading commences. Accordingly, abatement activities undertaken prior to 2011 should only receive credits until 2011, even though these credits would be recognised within the trading scheme thereafter.

In contrast, sectors not covered by the scheme (e.g. agricultural and forestry emissions) will continue to be able to generate offsets from additional abatement projects for sale into the emissions trading scheme until these sectors themselves are brought within the scheme.

Nevertheless, it is likely that a range of unexploited additional abatement opportunities exist now in both the covered and uncovered sectors which will not be taken up unless there is the prospect of achieving returns in terms of avoided permit liability under the future scheme or the prospect of selling offset credits into the scheme (in effect, bringing forward the carbon price incentive from 2011 to today). In principle, market participants should be able to generate credits for early abatement activities no matter where they occur in the economy. It is therefore proposed that all early abatement activities be eligible for credits under the scheme, whether they are from covered or uncovered sectors, provided they meet the rigorous approval standards outlined above. These credits would be fully tradeable prior to the formal commencement of the emissions trading scheme.

To avoid confusion with the terminology surrounding the ongoing operation of the scheme, eligible abatement activity in covered sectors will be referred to as 'early action credits', while abatement activity in uncovered sectors will generate 'offset credits'.

While these credits will be equivalent in operation, and may involve similar administrative processes (see below), there are a number of points to be made about early action credits. Firms have only a limited window of opportunity in which to develop project proposals, submit them for approval and generate credits. This makes it unlikely that significant volumes of early abatement action can be credited in the years prior to 2011. In addition, assessing the additionality of abatement activities in covered sectors becomes more complex with the announcement of an impending emissions trading scheme - firms are now likely to factor in emissions constraints into their business practices and decision making as part of business-as-usual.

Consistent with the commencement date for other scheme elements, it is proposed that the emissions trading scheme recognise abatement from eligible projects that occurs after 3 June 2007. This would apply to both offset projects recognised under the scheme and abatement projects eligible to create early action credits. Abatement could only be recognised for projects that

commenced after 3 June 2007 that satisfied additional eligibility criteria. These criteria are discussed below and would be only be operative were the Government to endorse this approach when it announces its early action policy in 2008.

Activities for which coverage has still to be determined (e.g. waste) will be treated as *though* they would be included within the scheme. In other words, eligible abatement from these activities would generate early action credits rather than offsets. If it is decided that these activities can not be covered initially, they would be eligible to generate offsets after the scheme formally commences.

Issues for stakeholder consideration

It is proposed that there be no restriction on the types of activities that can earn credits prior to 2011 for use in the emissions trading scheme, provided they represent abatement that is additional, has actually occurred, and is permanent, measurable, and verifiable.

It is proposed that early action credits be generated from eligible projects for abatement after 3 June 2007 until the commencement of the scheme due in 2011.

Similarly, it is proposed that offset credits for use in the emissions trading scheme can be generated from eligible projects for abatement after 3 June 2007.

To be eligible, it is proposed that projects would need to be established after 3 June 2007.

Abatement projects could only be approved following final decisions as to eligibility of activities for offsets or early action credits for use in a future emissions trading scheme.

3.3 Administrative arrangements

As noted, the key consideration in providing incentives for early abatement is to ensure the integrity and credibility of the emissions trading scheme. It is also important to ensure approval processes for such action are ready to implement in the near future and are as streamlined as possible. This will ensure abatement opportunities are maximised. This section outlines a proposed approach to implementing the above arrangements to achieve these objectives.

3.3.1 Initial arrangements – approval via *Greenhouse Friendly*

The Prime Ministerial Task Group on Emissions Trading suggested arrangements for early action should initially make use of existing standards, given the times frames involved. The Australian Government's *Greenhouse Friendly* initiative provides such an existing standard and administrative structure for approving offset credits. Credits approved under this programme meet high standards, thereby satisfying the integrity requirement emphasised above. **Appendix B** provides further detail on *Greenhouse Friendly* approval requirements.

One approach the Government is considering is for *Greenhouse Friendly* projects approved after any final decision by Government to proceed with the approach outlined in **Section 3.2** to be eligible to earn early action credits or offsets.

Greenhouse Friendly allows project developers to propose project-specific methodologies for calculating baselines and measuring abatement. For example, firms can use or adapt methodologies developed for other programmes in Australia or internationally or develop new methodologies. *Greenhouse Friendly* has a rigorous process for assessing and approving these methodologies to ensure projects meet the required standard.

In addition, *Greenhouse Friendly* provides detailed guidance on issues, such as the methodologies for calculating baselines, for some common types of projects. These guidance documents (also called protocols) streamline the process for approving the creation of offsets by assisting project developers to improve the consistency and quality of their project documentation.

A protocol already exists for offsets from new carbon sink forests and so provides an approach to forest offsets that can be implemented quickly and at relatively low administrative overhead. It is proposed that this standard be reviewed in 2008 in close consultation with stakeholders to ensure it remains appropriate for ongoing use under the emissions trading scheme¹¹.

Abatement projects that meet programme requirements receive approval to generate *Greenhouse Friendly* offsets for a defined period, after which projects must seek re-approval. Importantly, offsets are only created as the abatement actually occurs, while the re-approval process allows the continuing additionality of the project to be periodically assessed.

Issues for stakeholder consideration

It is proposed that the Australian Government's Greenhouse Friendly programme provide the initial administrative mechanism for approving offsets and early action credits for use in the emissions trading scheme.

It is proposed that the existing Greenhouse Friendly protocol for new forest offsets be used to assess eligibility following any Government decision, but be reviewed in 2008.

3.3.2 Streamlining administration of offsets and early action credits

The development of additional protocols would help streamline the processes for approving offset and early action credits.

Protocols are not currently available for other agricultural and forestry offset activities outside carbon sink forests. The Government, therefore, proposes to progressively develop protocols for other offset activities as abatement technologies become available and measurement methodologies are developed – see discussion below. For example, various methodologies exist for abatement from animal waste management systems while approaches to enhancing soil carbon and fertiliser management are the subject of active research and development.

Greenhouse Friendly does not yet have protocols for most abatement activities that will be eligible to generate early action credit. However, various methodologies for measuring abatement and calculating baselines have been or are under active development both in Australia and internationally. The approval process for the most promising sources of early abatement could be streamlined were the Government to develop protocols for these activities, based on internationally available methodologies or methodologies developed for other government programmes. It is proposed, therefore, that priority be given to developing protocols for activities that can commence quickly, deliver significant abatement and clearly demonstrate additionality¹². It is expected that the great majority of early action projects would gain approval to create credits through use of these

¹¹ Projects would be approved to create offsets in accordance with the relevant protocol in place at the time. Projects would not be re-assessed, nor previous abatement re-calculated, as a result of changes to the protocol or to other rules under *Greenhouse Friendly*.

¹² Examples of possible activities include methane capture and destruction, energy efficiency measures with high risk longer pay back periods, step change electricity generation technologies (eg coal drying) and waste methane projects.

protocols. Stakeholder feedback is sought on activities for which protocols could be developed as a priority.

The National Greenhouse and Energy Reporting Bill (NGER Bill) provides a legislative option to further streamline approval, monitoring and verification of offsets and early action credits. *Greenhouse Friendly* currently enforces the conditions attached to offsets via deeds of agreement which involve administrative overheads for both Government and proponents. Moving administration of offsets and early action credits into a legislative framework could streamline these processes. Stakeholder consultation has begun on regulations to underpin the NGER Bill and opportunities may exist for streamlining offset approval and reporting.

Issues for stakeholder consideration

It is proposed that streamlined protocols be developed for eligible early action and offset projects. Stakeholder feedback is sought on priority project activities for protocol development.

3.4 National register for offsets and early action credit

A national register for offsets and early action credits would facilitate trading in these commodities prior to the formal commencement of the scheme. It would also allow market participants, and ultimately the scheme regulator, to be sure that only one offset credit is created for each tonne of approved abatement and that ownership of offsets is transparently tracked from creation to retirement. The Government, therefore, proposes to develop a national offset register to track all dealings in relation to credits which could be recognised in the emissions trading scheme.

Issues for stakeholder consideration

The Government proposes to develop as soon as practical a national offset register to track early action credits and offsets that could be recognised under the emissions trading scheme.

3.5 Developing offset standards for the emissions trading scheme

The emissions trading scheme regulator, which the Government intends to establish in 2009, will ultimately be responsible for amending and approving new offset protocols and offset projects that meet the standard required for recognition in the emissions trading scheme. Indeed, offset protocols are 'living' documents that will evolve to reflect changes in scientific understanding and technologies available to measure emissions.

The Government proposes to use *Greenhouse Friendly* administrative framework and standards as the starting point for developing offset arrangements for the emissions trading scheme, including for approving new offset protocols.

The Task Group indicated that eligible offsets should not be restricted to activities included in current international standards, and that Australia has an interest in exploring crediting of new abatement activities provided they can meet rigorous and credible standards for abatement. For example, the Government would examine options, in consultation with stakeholders, for measuring abatement from activities not yet internationally recognised, including carbon sequestered in harvested wood products and new avoided deforestation. The Government will investigate the development of robust methodologies for developing offsets from these activities for use in its domestic scheme and internationally.

3.6 *Transitioning early action credits into the emissions trading scheme*

The Government proposes to introduce legislation establishing the emissions trading scheme, including the scheme regulator in 2009¹³. This legislation would include provision for the scheme regulator to exchange early action credits for the same number of emissions permits dated for use in the first year of the scheme. Any limitations that might be imposed on banking of permits in the early years of the scheme, while the safety valve emission fee was set low, would need to apply equally to these permits¹⁴.

The Task Group report noted it may be necessary to adjust the emissions cap to reflect expected early abatement in order to maintain the integrity of the scheme's emissions constraint. The initial caps will be set very carefully to avoid unnecessary economic costs and ensure a smooth transition for the economy. The volume of likely early action credit and available offsets would be one of the factors taken into consideration in this process.

The Task Group also noted it may be necessary to set limits on the volume of early action credits to ensure that no issues arise relating to the integrity and credibility of the emissions trading scheme. There are, however, a number of factors likely to impose natural limits on the number of offsets created prior to the 2011 start date: current shortages in the supply of credible offsets for the voluntary market; the lead times for development and approval of project proposals, and for establishing abatement projects; the limited crediting period for early action projects (from 3 June 2007 – end 2010); and transaction costs for approving credible offsets. This suggests that early action offsets will form only a very small proportion of total permits required in the initial years of the trading scheme. Therefore, the Government does not propose to impose any quantitative limits on early action credits.

Issues for stakeholder consideration

It is proposed that the scheme regulator exchange early action credits for emissions permits dated for use in the first year of the scheme.

It is proposed that there be no limits on the number of early action credits that would be recognised.

It is proposed that early abatement be taken into consideration when setting the emissions caps in the initial phase of the scheme.

3.7 *International activities and abatement recognised by other domestic mandatory schemes*

One of the key design features of the scheme outlined in the Task Group report is inclusion of credible international offsets. Inclusion of international offsets, however, raises a range of complex issues relating to policy and administration and further consultation will be undertaken in 2008 on these matters.

Australian firms contemplating investing in international offsets, including CDM offsets, should be aware that no decisions have been made regarding the categories or vintages that may in future be included in the emissions trading scheme.

¹³ Formal permit trading is not intended to commence until 2011.

¹⁴ Report of the Task Group on Emissions Trading, page 111.

Further consideration and consultation will also occur in relation to transitional arrangements for participants in existing mandatory programmes such as the Greenhouse Gas Abatement Scheme.

3.8 Voluntary market access to offsets accredited for use in the emissions trading scheme

The recently released *Climate Change Policy* indicated the Government would consider making the emissions trading scheme offset standard available to the voluntary market. This will help standardise the quality of offsets available in the voluntary market. In the meantime, the Government notes that purchasers of offsets and carbon neutral products should be wary of products that are not accredited by a reputable source.

A range of offset schemes have emerged to service the voluntary market. While some are of high quality, others have opaque standards or allow crediting of business-as-usual abatement. Without a national offset register, there is also no simple means of tracking offset transactions to ensure that abatement is not sold more than once or determining when offsets have been retired or used to meet carbon neutral commitments. As offsets would need to meet certain standards in order to be registered, a national register also provides market participants with a simple means of determining whether offsets have met appropriate standards.

Providing the voluntary carbon market with access to offsets that are approved for use in the emissions trading scheme could reduce transaction costs and promote growth in voluntary demand for carbon offsets. It would also allow offset providers to supply both the voluntary and mandatory carbon markets without them having to undergo separate accreditation or registration under voluntary schemes. Recording all offsets meeting these standards on a national register would also provide a means of tracking use and ownership of offsets. It is, therefore, the intent of the Government that any administrative processes and standards that may be developed for offsets accredited for use in the emissions trading scheme would be available for voluntary providers.

It is proposed that participants in the voluntary market would have access to early action credits and offsets credited for use in the emissions trading scheme.

APPENDIX A

COMPENSATION - DEFINING ASSETS IN EXISTENCE

The Prime Minister has confirmed that only assets in existence as at 3 June 2007 would be eligible for consideration under the Government's proposed compensation arrangements.

Stakeholder feedback is being sought in relation to the definition of an asset "in existence" at the cut-off date.

In the electricity generation sector, the definition of a "committed project" under the National Electricity Market provides useful guidance as to the range of assets which would be likely to satisfy the principles of an asset "in existence".

The relevant criteria for assets in this sector would include the following:

- "The project proponent has acquired, or has commenced legal proceedings to acquire land for the construction of the project.
- Contracts for the supply and construction of the project's major plant or equipment (including generators, turbines, boilers, transmission towers and conductors), including provision for project cancellation payments, have been executed.
- The project proponent has obtained all required planning and construction approvals and licences, including completed and approved environmental impact statements (these include planning and environmental approvals from duly authorised planning bodies at both State and Federal Government levels).
- Financing arrangements for the proposal, including debt plans, have been finalised and contracts executed.
- *Construction has either commenced or a firm date has been set for it to commence.*¹⁵

These criteria may need to be amended slightly to provide additional guidance for other industries. The key elements of any amended criteria will need to clarify the nature of the contractual and financing arrangements already entered into and the date and associated commitments made in relation to the physical construction of the asset.

Feedback is sought in relation to the guidance afforded by the use of the NEM definition and criteria for the electricity generation sector, and any necessary amendments to the criteria that may be necessary for other industries.

¹⁵ NEMMCO 2005, *Statement of Opportunities for the National Electricity Market*, October, pp. 1-9.

GREENHOUSE FRIENDLY OFFSET STANDARD

Offsets approved under the Australian Government's *Greenhouse Friendly* initiative are consistent with the highest international standards. *Greenhouse Friendly* approved offsets must be:

Additional – projects must be demonstrably beyond business as usual activities.

- The *Greenhouse Friendly* guidelines require that all approved projects can demonstrate that the project activity is beyond business-as-usual activities. This means that project proponents must be able to show that in the absence of *Greenhouse Friendly* carbon offsets, the project would not have gone ahead. The additionality of all *Greenhouse Friendly* approved projects must also be independently verified.

Calculation – projects must use internationally accepted best practice methodologies for the calculation of their emissions reductions and/or sequestration

- *Greenhouse Friendly* approved projects must use the internationally accepted calculation methods contained in the AGO's Factors and Methods Workbook or alternative factors approved by the AGO. All calculations and methodologies must be independently verified.

Verification – projects must be *independently* verified to ensure that all offsets claimed are genuine and accurately measured.

- All approval documentation (including demonstration of additionality and project monitoring plans), all annual reports and *all* claims for approval of offset credits generated must be independently verified under *Greenhouse Friendly*.
- Independent verification under *Greenhouse Friendly* must be undertaken by a member of the Australian Greenhouse Office's approved panel of verifiers.

Permanence – all offset credits generated by a project must represent a permanent removal of greenhouse gases from the atmosphere.

- This is particularly important for reforestation projects. Australia is considered world-leading in the provision of legal arrangements and frameworks to ensure permanence. Under *Greenhouse Friendly* all approved projects must demonstrate that the emissions reductions they achieve will be permanent – this can be done through strict legal arrangements in the case of forestry projects.
- To ensure permanence, *Greenhouse Friendly* approved projects must also demonstrate that there will be no leakage of emissions to other sites as a result of the project – this must be independently verified as part of the approval process.

Monitoring – projects must be regularly monitored.

- *Greenhouse Friendly* approved projects must report annually and undertake regular monitoring in accordance with their approved project monitoring plan. Under the *Greenhouse Friendly* programme, project proponents are legally responsible for anything that may reduce the offsets generated by the project.
- In the case of forestry projects in particular, *Greenhouse Friendly* sets out a number of strict restoration requirements, should any event reduce the sequestration capacity of an approved forest sink. These legal arrangements are considered world-leading for the protection of carbon credit integrity in forestry-based offset projects.