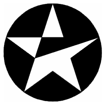

CALTEX
Caltex Australia

2 Market Street
Sydney NSW 2000
Tel: (02) 9250 5000
Fax: (02) 9250 5742

GPO Box 3916
Sydney NSW 2001
www.caltex.com.au

31 March 2009

Mr John Hawkins
The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Mr Hawkins

Re – Inquiry into the exposure drafts of the legislation to implement the Carbon Pollution Reduction Scheme.

Caltex Australia Limited welcomes the opportunity to comment on the draft legislation to implement the Carbon Pollution Reduction Scheme (CPRS). Because Caltex must purchase permits for its customers' emissions as well as its own emissions, it will be Australia's largest single purchaser of emission permits so has a vital interest in the effectiveness of the CPRS.

The issues contained in the exposure draft bills will have a serious impact on Caltex. Our international competitiveness will be adversely affected and the purchasing of permits on behalf of our customers will place an inequitable and disproportionate financial risk and cost on the business. Certain provisions of the Carbon Pollution Reduction Scheme Bill 2009 and the Carbon Pollution Reduction Scheme (Consequential Amendments) Bill 2009 need to be amended to remove the adverse impacts on Caltex.

Regarding the proposal for the scheme to commence on 1 July 2010, Caltex is not fixed on a particular implementation date. Sufficient time must be taken to ensure the scheme is fully and properly designed and reviewed and it should be implemented fully when economic times return to normal.

This submission concentrates on sections of the bills most relevant to Caltex: namely the emissions intensive trade exposed assistance program, coverage and point of obligation, taxation, accounting and administrative issues.

1. Background

Caltex is the largest refiner and marketer of petroleum products in Australia with operations in all states and territories. Caltex has achieved the leading market share for supply of transport fuels and is the number one convenience store operator through its national retail network. It has an estimated market share of more than 30 per cent of the major transport fuels sold nationally.

Caltex accounts for around 35 per cent of the nation's oil refining capacity. It owns and operates two of Australia's seven oil refineries – at Kurnell in Sydney and Lytton in Brisbane. Between them the Caltex refineries have the capacity to process 244,000 barrels (about 39 million litres) of crude oil per day.

Caltex produces mostly high-value transport fuels which contribute to the growth of the economy and provide significant employment. The two refineries directly employ 874 Caltex employees and around 550 contractor employees. For major maintenance and other projects the numbers can escalate to an extra 1,200 workers bringing the total number of workers to about 2,600.

Caltex refineries will spend an average of $100 million per year over the next three years on capital expenditure and approximately $60 million per year on turn-around and inspections.

2. Carbon Pollution Reduction Scheme Bill 2009

2.1 Importers, producers and suppliers of eligible upstream fuels (Part 3 Liable entities Division 4)

The bill requires liquid fuel suppliers to purchase permits for their customers' greenhouse gas emissions then pass on the cost at the pump.

Under the CPRS, the Government will cut fuel taxes to offset the carbon price impact on fuel prices for many users. The Government will assess the adequacy of this measure and adjust the excise reduction accordingly over the first three years. After July 2013, the Government will make a final assessment and, if needed, a final fuel tax cut will take effect from 1 August 2013. This final tax cut will be made permanent.

The excise reduction will reduce the price of petrol for several years because it is based on the carbon intensity of diesel rather than petrol. This means that emissions from petrol under the CPRS will increase relative to emissions without the CPRS. Emissions from many diesel users will be unchanged for three years because of the excise reduction then will be reduced more slowly than without the CPRS.

Applying the excise offset effectively removes petrol emissions from the CPRS for many years and greatly reduces the impact of the CPRS on diesel emissions yet places a significant burden on Caltex to purchase permits on behalf of our petroleum customers.

Caltex calculates that by 2021, cumulative emissions from petrol will be the same as without the CPRS yet the oil industry will have purchased $15 billion in permits and charged them back to customers. This is financial churn with associated financial risk and cost for no effect other than to create fees for financial intermediaries. At the prices estimated in the CPRS, purchasing approximately 40 million tonnes of customers' permits would cost Caltex $0.9 to $1.6 billion dollars annually. In contrast, Caltex's after tax profit for 2008 was $186 million on a replacement cost of sales operating profit basis. Caltex recorded an after tax profit of $34 million on a historical cost profit basis.

Longer term, the CPRS is projected to increase petrol and diesel prices in the order of 10 cents per litre (prices for 2020, CPRS -5 case, expressed in 2005$) but this will reduce emissions by only a few per cent. The CPRS will not deliver the solution Australia needs to greatly reduce emissions from vehicles and other mobile equipment by 2050.

The way the CPRS has been formulated, one has to seriously question why motorists are included. Caltex is examining this question and will be able to provide further information to the Senate in a submission to the Select Committee on Climate Policy.

Another issue is the absence of price transparency. Fuel prices will go up because of market prices for carbon but the excise reduction will be based on prices up to a year before. Carbon markets could be very volatile and Caltex does not want to be accused of creating a mismatch between carbon prices and the excise reduction that disadvantages motorists.

To avoid this problem, if the CPRS white paper policy is pursued, the price of carbon permits for petroleum products should be exactly matched to the excise reduction. This could be achieved by issuing fuel suppliers with permits for customers' emissions at a fixed price equal to the pre-determined excise offset.

Caltex's experience shows price does little to change motorists' consumption behaviour and that the necessary changes to reduce GHG will inevitably come from new vehicle technologies, with carbon prices having little impact on this technological change. Once new vehicle technology becomes economical drivers will switch from fossil fuels to electric vehicles and vehicles using other renewable non-fossil fuels, including biofuels. The focus has to be on reducing emissions from consumption of liquid fuels, not their production, as emissions from use of liquid fuels are about 15 times emissions from production in Australian refineries.

Recommendation

The current proposal for an upstream point of obligation for all petroleum products is badly flawed and needs to be reassessed.

2.2 National scheme cap and national scheme gateway (Part 2 Section 15)

The White Paper established the concept of minimum and maximum greenhouse gas reduction targets for up to a five year period, described as the gateway and recommended that an annual cap on emissions would fall within that gateway.

The legislation in its current form states that the Minister must take all reasonable steps to ensure that the national scheme cap for an eligible financial year falls between the gateways.

There is no mandatory requirement to meet the gateways.

The consequence of providing this flexibility to the Minister leads to uncertainty for industry to be able to plan in any meaningful way for future investment based on published gateways. Operational uncertainty is heightened in the absence of clear and confirmed maximum and minimum emission caps.

Recommendation

The bill should require the Minister to set the national scheme cap within the published gateways.

2.3 Obligation transfer numbers (Part 3 Division 5)

There are a number of issues relating to the obligation transfer number (OTN) which need to be clarified in the legislation and the regulations in order to manage an organisation's future liability under the ETS, the point of obligation and the administration of the OTN.

- The Authority has 90 days to determine an application for an OTN and the basis for refusal is not known.
- The fee payable is yet to be confirmed and clarity regarding the application of the OTN for subsidiary businesses is required.
- The cancellation or surrender of an OTN will need to be communicated in a timely fashion. However there are no mechanisms or protocols identified to ensure this occurs.
- An OTN must not be accepted if the OTN is not on the OTN Register, as this requirement will present additional and unacceptable compliance costs in verifying customers' OTNs for every transaction as OTNs can be cancelled by the Authority. It is not practical to undertake this verification process.

Recommendation

1. Bring forward the regulations with regard to the application of the OTN to ensure supplier entities are able to establish their level of liability and to set up systems to manage their exposure as early as possible.

2. The legislation should remove the requirement to verify the OTN on the OTN register for every transaction. The OTN system should provide for the supplier to check the OTN of the recipient only once at commencement of the agreement to supply product.

3. Where an entity misuses or uses a bogus OTN, the penalties and liability for the associated emissions should transfer to the recipient with no recourse on the supplier provided the supplier has not acted inappropriately.

2.4 Emissions units (Part 4)

Policies, procedures and rules for auctioning Australian Emissions Units. (Division C Section 103)

This provision does not outline the design of the auctioning system but enables the Minister to determine policies, procedures and rules that apply in relation to auctioning of Australian Emission Units in a separate legislative instrument until 1 Jan 2012 when the Authority takes over. This means the design aspects are still not clear.

If the provisions of the White Paper apply we would have significant concern around the limit of parcel size to 25%. Based on 16 auctions this means that any entity can only bid for a maximum of 1.5% of auctioned permits. As Caltex has a liability in the order of 40 million tonnes or approximately 12% of the auctioned permits this significantly increases the need for us to successfully secure our maximum quota of permits at each auction, thereby potentially raising the price we will need to pay. Without

certainty as to the structure and regulatory requirements in relation to the auction system, business is not able to plan adequately.

Recommendation

Draft regulations must be provided as a matter of urgency so that requirements relating to procedures, policies and the rules for auctioning can be clarified.

2.5 Non-Kyoto international emission units (Division 4)

The detail relating to non-Kyoto emission units is not yet available. However there is concern that there is provision for additional permits to be established under the CPRS. This has the potential to have a significant destabilising impact on the market.

Recommendation

Regulations should be brought forward in a timely manner to clarify this issue.

2.6 How eligible emission units are surrendered (Part 6, Division 2, and Section 129 Subsection 4)

The legislation states that an Australian Emission Unit (AEU) must not be surrendered in relation to an eligible financial year unless that eligible financial year is the eligible financial year immediately proceeding the vintage year of the unit. This position was not articulated in the White Paper.

This restricts borrowing to only the next vintage year and sets a 5 per cent limit (Division 3 Section 130 subsection 4). This limits the value of participating in auctions of future vintages as the cash cost of holding future vintages is likely to be substantial if they cannot be used to meet an earlier liability. Having the flexibility to surrender permits which were aligned to future liabilities when plans change should be allowed under the scheme.

Recommendation

There should be no restriction on which future vintages an organisation can draw upon for its borrowing limit.

2.7 Emissions-intensive trade-exposed (EITE) assistance program (Part 8, Division 1-3), regulation of principles

There are no regulations covering the EITE assistance program for consideration in conjunction with the draft legislation. Detailed analysis is therefore limited and it is not possible to assess the impact of the CPRS with the limited information available on eligibility, quantum or administrative issues.

Regulation is currently being developed by the Department of Climate Change (DCC) in consultation with EITE industries on the definition of activities that will allow DCC to determine eligibility for free permits. This determination will be made by DCC officials without external scrutiny apart from an Expert Committee that will advise the Minister for Climate Change on EITE issues. This process means that the crucial EITE permit eligibility rates will not be subject to Parliamentary scrutiny except through a disallowance motion, which means they may not be amended, only accepted or rejected.

Recommendation

Key provisions relating to EITE permit eligibility should be part of the bill, not embodied in regulation. Such provisions could include principles for EITE activity definitions (such as definition of value added) and the principle of full maintenance of international competitiveness.

2.8 Emissions-intensive trade-exposed (EITE) assistance program (Part 8, Division 1-3), permit allocation

International competitiveness must be maintained, which in practice means a 100 per cent free allocation of permits must be provided for in the bill. Until overseas refineries such as those in Singapore bear equivalent carbon costs the allocation of 60 per cent or even 90 per cent of permits exposes the industry to additional costs that cannot be passed on to customers. Failure to implement provisions within the bill to provide a 100 per cent permit allocation to trade exposed industries threatens to destroy Australian investment and jobs without reducing global emissions.

Australia imports 30 per cent of the petroleum products it needs and this figure will increase over time. Large, low-cost Asian refineries have competitive advantages, including closer proximity to

growing markets and lower capital and labour costs. This means that no new refineries are likely to be built in Australia.

Australian refineries can be competitive but not if they are hampered by extra costs that tilt the playing field against them. Once competitors have the same carbon costs, Caltex is willing to bear the same costs and emission trading should work as intended to help reduce emissions, although the potential for emission reduction from existing oil refineries is small because of the high cost of replacing equipment.

The petroleum product market in the Asian region will continue to be impacted by the global economic slowdown throughout 2009. Significant new refining capacity is expected to be commissioned over the next two years, expanding regional product supply, while demand will contract due to declining industrial activity and consumer confidence.

Against this backdrop of decelerating demand, the region is entering a phase of increased supply of refined products. Several key refining projects in Asia are now set to either commence operations or to ramp up capacity e.g. China's Huizhou and Quanzhou refineries, Vietnam's Dung Quat refinery and India's Reliance plant. Energy Security Analysis Inc. forecasts that Asia's petrol surplus will average 120,000 b/d for the year while diesel surplus is projected to increase to a massive 600,000 b/d by the third quarter of 2009.

In the near term, lower demand growth in Asia because of the global economic crisis, combined with new refining capacity will reduce refining profitability in the Asia-Pacific region.

The need to purchase 40 per cent of permits would cost Caltex's two refineries about $25 to $40 million annually at the carbon prices in the White Paper (CPRS-5 and price cap cases). This would seriously reduce the funds needed to keep them running reliably and efficiently. In the bottom half of a business cycle such as now, carbon permit costs for refining could consume a significant percentage of our earnings as the costs will not be recoverable from customers. Large carbon costs would greatly increase the risk associated with the refining business. As refineries already consume large amounts of energy they focus closely on energy efficiency. Consequently, there is not much scope to reduce greenhouse gas emissions through further efficiencies. This makes the CPRS a tax on competitiveness instead of an incentive for emission reduction.

The introduction of the CPRS will exacerbate the impacts of the economic slowdown. Emissions from refinery operations cannot be passed through to the market as no such cost impost exists on the products imported from countries like Singapore and Korea. Under the proposed CPRS legislation, the cost of these emissions will be borne by Caltex.

With the petroleum product market facing a protracted period of weak refiner margins, the additional cost of the CPRS will pose a significant challenge for Caltex in maintaining competitiveness against regional refiners, and our profitability in the Australian market. To ensure a secure and flexible petroleum product supply chain, Australia needs a local refining industry. The CPRS in its current form threatens the viability of Australian refining.

Australian refineries offer the critical supply diversity that underpins security of fuel supply to Australian industry, businesses and consumers. We believe it will be difficult and more costly to maintain our historical high level of fuel supply security if the vast majority of fuel supply is imported.

Recommendation

Caltex recommends that the Carbon Pollution Reduction Scheme Bill 2009 be amended to provide for 100 per cent permit allocation to EITE industries.

2.9 Notification of significant holding of Australian emissions units (Part 16)

Controlling corporations must report significant holdings (5 per cent or more of any vintage) of emission units held within five days of becoming aware of the event. Organisations will need a system to keep track and notify the authority in the required form. There are civil penalties for breach of this requirement.

The application of this provision is unclear and in practice could prove to be onerous. It is possible that an organisation could hold 5 per cent or more emission units for legitimate purposes due to its liability. For instance Caltex has a liability of approximately 40 million tonnes which is about 12 per cent of the likely available permits in the first year of the scheme. The legislation does not provide any guidance as to what period of time will qualify as a holding.

Recommendation

Raise the limit of notification of significant holding to 20 per cent. This level of holding is more likely to signal behaviours likely to be associated with market manipulation as it is in excess of any individual entity's liability.

2.10 Monitoring Powers (Part 19)

The powers and penalties would appear to be broad reaching. Inspectors may enter premises for the purposes of determining whether the Act or associated provisions have been complied with; or substantiating information provided under this Act or associated provisions. Section 309 1(e) states that an inspector may exercise power to inspect any document on the premises.

Inspectors should not have the power to inspect all of an organisation's documents; their power should be limited to only inspecting and monitoring those documents relating to the CPRS scheme.

Recommendation

Amend Section 309 1(e) to read "to inspect any document relevant to determining whether this Act or the associated provisions have been, or are being, complied with."

3. CPRS (Consequential Amendments) Bill 2009 - Schedule 1

Caltex has identified a number of policy positions in the *CPRS (Consequential Amendments) Bill 2009* – Schedule 1 which will substantially increase its operating costs, working capital, debt financing and reduce Caltex's ability to fund future developments.

In assessing the impact of the CPRS on Caltex, it is necessary to recognise the volume of the carbon permit market for which Caltex is facing liability through the upstream point of obligation, as discussed earlier in this submission. The taxation implications of the CPRS are exacerbated by the volume of permits which Caltex must fund and process.

3.1 Amendments commencing at the same time as section 3 of the Carbon Pollution Reduction Scheme Act 2009 commences, Part 1 Division 1

Amendments to Australian Securities and Investments Commission Act 2001 and Corporations Act 2001.

Organisations wishing to trade permits and participate in auctions directly without a broker or a financial intermediary will need to hold a financial services licence. This has the impact of restricting a liable organisations ability to manage their permit liability directly and forces them to use the services of financial intermediaries in order to avoid the additional compliance burden of holding a financial services licence.

Recommendation

The CPRS should treat carbon permits as a commodity, similar to the approach taken in the UK for the EU scheme. This would remove the requirement to hold a financial services licence. It is possible to regulate against market manipulation through proposed provisions such as parcel size restriction and notification of holdings.

3.2 Amendments commencing on 1 July 2010 Part 2, Sec 146, Insert of Sec7A (e) to NGER Act

This allows for the Authority to prescribe additional greenhouse gases beyond the six Kyoto gases.

The CPRS Bill 2009 also allows for the regulations to add additional gases. It is unclear if EITE assistance will be modified for any new gases.

Recommendation

EITE assistance has been calculated on the six Kyoto gases, to regulate additional gases to be incorporated in the Scheme, EITE assistance measures would need to be amended to reflect the additional liability and maintain the proportion of assistance.

3.3 Mismatch between expenditure on a permit, the surrender of a permit and the end of an income year under the rolling balance method (Ref Part 3-50 Carbon Pollution Reduction Scheme Division 420)

For income tax purposes, companies are currently able to immediately deduct legally incurred liabilities in the tax reporting year. Examples of such liabilities include salaries and wages, rentals, duties, consumables, electricity and gas. These operating costs are incurred in that they are pre-determined and legally committed to as expenses necessarily incurred in operating the business. Income tax law accordingly recognises them as existing liabilities and thereby qualifying as an immediate deduction in the financial year in which the funds are incurred, even if the cash expenditure is not undertaken until the following financial year.

Under the CPRS, the cost of carbon permits on hand at year end is not recognised as an immediately deductible liability unless the permit has already been sold or surrendered to the government. This is inconsistent with the treatment of other costs. Deductibility may not occur until the ultimate date of surrender, on 15 December in the following income year, thereby leaving a significant cost associated with the carrying of permits still on hand at year end for which the company remains liable.

As the legislation does not enable immediate deductibility, Caltex will be required to pay this tax burden in one calendar year only to deduct it in the following year, which will impact cash flow, financing costs including interest in the range of 6-7 per cent per annum, and the loss of working capital to invest in future developments. Apart from these financial implications, the proposed tax treatment could distort strategy relating to the timing of permit purchases.

As Caltex purchases permits for consumer emissions, and the policy intention is for that cost to be passed onto consumers, then the administrative and financing costs should not disadvantage Caltex.

Recommendation

In order to minimise significant cash flow disadvantages on the industry, permits held at year end and used to acquit an entity's liability on 15 December should be deemed to be surrendered for income tax purposes in the financial year in which the expense was incurred.

3.4 Valuation methods under the rolling balance system

The current tax system enables companies to choose the measure of value for tax liability of trading stock at cost price, net realisable value or market selling price. This principle is applied to ensure that taxation liability matches the financial performance of a company and recognises that companies should not be financially disadvantaged by changes in the market prices of goods sold.

This is applied to all inventory providing companies with the choice of applicable methodology.

The CPRS proposes only two options; the cost price or market selling price option. Companies must choose only one of these valuation measures during the transition period (up to 2015) for their tax valuation methodology of carbon permits. Companies will be locked into their choice of valuation measure.

If companies are not permitted to have the flexibility to determine their tax valuation methodology, they will be exposed to tax liability fluctuations which will impact cash flow and financial performance.

Recommendation

Companies should be given an opportunity to elect which tax valuation methodology they adopt on a year to year basis.

3.5 Application of GST

The structure of the GST claims system will impact companies' cash flow and working capital in the areas of financing and compliance.

As companies must pay upfront for GST when incurring the cost of a product and can only claim back the GST paid on carbon permits with the lodgement of a BAS, there will be a period in which companies must hold the financial liability of that GST expense. Between the date of payment and the date of obtaining the benefit of input tax credits (at least three weeks but most likely longer), companies will bear the cost of being unable to use the funds which have financed the GST liability.

If trading under the CPRS were GST free, pressure on cash flows and funding costs would be relieved. As companies will receive an input tax credit equal, in principle, to the amount of output tax, the proposed treatment of trading as taxable will not produce any net revenue. If trading were instead GST free, there would be no net difference to revenue collections. This is the standard proposed to be applied in New Zealand where trading in emissions units will be zero rated (i.e. GST free.)

The treatment of trading as GST free would also relieve companies of the additional administrative burden of accounting for output tax and claiming input tax credits.

The use of derivatives can be expected to form an important part of the emissions trading market. This is because the use of financial derivatives to hedge risk of price volatility in the current energy market is expected to extend to hedging risk in the emissions trading market in the same way. The policy objective of avoiding trapped GST (i.e. inability to pass on GST) arising out of the CPRS may not be met if such derivatives trading were input taxed.

Currently the GST rules prescribe a $500,000 per annum threshold for input tax credit entitlements. If Caltex exceeds this threshold, it will be liable for all costs associated with financial supplies including derivatives (including current hedging activity not associated with carbon permits). Caltex will also need to add administrative capacity to identify all suppliers for subsequent reporting periods and the previous 13 months.

As there are GST costs associated with trading in financial derivatives, the volume of permits to be traded would increase the associated costs to the point where they are likely to surpass the $500,000 per annum threshold for input tax credit entitlements.

In order to avoid trapped GST arising out of trading under the CPRS, trading in carbon derivatives underpinned by permits should be treated in the same way as trading in permits themselves.

Recommendation

That trading of permits and the associated derivative products should be GST free.

3.6 Alternative recommendations - if permits remain taxable supplies

If taxable treatment of permits remains unchanged, one way to alleviate the financial burden in respect of permits is to introduce a deferral scheme similar to the current scheme used for imports. This system defers the GST liability of imported crude and product until the time that the BAS is due for lodgement, enabling a business to claim its input tax credits for the purchase of permits without resulting in loss of cash flow from GST timing differences.

If dealings in permit derivatives are not made GST free, substantially raising the financial acquisitions threshold from the current amount of $500,000 may assist. This would ensure that the necessary acquisition of derivatives to hedge carbon prices does not also lead to a substantial increase in compliance costs associated with the input taxed supply provisions. Consideration should be given to completely excluding the trading in carbon permit derivatives from the "financial acquisitions" definition.

Yours sincerely

Frank Topham
Manager Government Affairs & Media