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4 June 2009

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

Dear Mr Hawkins

Please find attached a submission to the Inquiry into the Carbon Pollution Reduction Scheme Bill 2009 and related bills.

I would be pleased to discuss the submission.

Yours sincerely

Frank Topham
Manager Government Affairs & Media

Caltex submission to inquiry into the Carbon Pollution Reduction Scheme Bill 2009 and related bills

4 June 2009

1. Introduction

Caltex Australia Limited welcomes the opportunity to comment on the legislation to implement the Carbon Pollution Reduction Scheme (CPRS). As 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.

Caltex has been engaged in the development of the CPRS providing feedback to the Green and White papers, Garnaut Review, CPRS draft legislation, as well as a number of Government inquiries and hearings.

Caltex accepts the science behind global warming and supports setting a goal for reducing greenhouse gas emissions and the introduction of a carbon pricing mechanism to assist the achievement of this goal. However, the current package of CPRS legislation is flawed and requires substantial amendment to ensure it is environmentally effective, equitable and economically efficient.

Caltex welcomes the one year delay in the start of the scheme to 1 July 2011. Caltex has argued the CPRS should not start operation until economic conditions return to normal and there is a greater probability of this occurring by mid-2011. The $10 per tonne fixed carbon cost in the first year of the scheme will also assist but will nevertheless impose millions of dollars of unrecoverable costs on Caltex's oil refineries.

We are disappointed the Government still seeks passage of the legislation in June this year. Caltex believes the Government should take whatever time is necessary to get the design of the scheme right and there is considerable work still to be done in this regard.

A substantial amount of regulation should be tabled so it can be debated and voted on with its enabling legislation. We would also like Parliament to amend the bills to include more of the regulation content, rather than have the regulation presented on a take it or leave it basis. Significant issues including the treatment of EITE industries, the application of OTNs, eligible emission units being defined as financial products and deferred payment arrangements for auction are going to be subject of regulation.

The change to the assistance for emissions-intensive, trade exposed (EITE) industries announced on 4 May 2009 will do little to relieve the burden that will be imposed on Caltex's two oil refineries. We currently expect a nominal assistance rate of 60% although this is still subject to negotiation with the Department of Climate Change and the Government. The proposed Global Recession Buffer will reduce the CPRS productivity tax from a nominal rate of 40% to 34% for five years, which does little to cut the burden in the first five years and nothing in the longer term.

The 60% assistance rate means a $25 to $40 million per year burden that will not be recovered from customers because we are fully exposed to import competition from overseas refineries that will not have a carbon cost on their emissions. The Global Recession Buffer reduces this burden to $20 to $35 million, still a very large amount of money that will do nothing to reduce Australian or global emissions.

The CPRS as it applies to our refineries is effectively a productivity tax as we have very few economic opportunities to abate emissions from our refineries. A significant part of the carbon cost will have to come from a reduction in capital expenditure, which will reduce refinery productivity and viability over time.

Oil refineries and EITE industries overseas will not face such a financial burden, even in countries and regions with emissions trading schemes. In the United States, the latest version of the Waxman-Markey Bill ensures that energy intensive and EITE industries will receive free permits until 2026, with no decline factor. The level of free permit allocation is likely to be the subject of intense debate in Congress. In the EU, there is currently a high level of free permit allocation to EITE industries and considerable pressure to extend the high level of free allocation beyond 2012.

Caltex is disappointed the Government did not take the opportunity of the recent CPRS update to scrap the application of the CPRS to motorists and light commercial vehicles. As discussed in detail in Caltex's submission to the Senate Select Committee on Climate Policy, the excise reduction provisions in the CPRS actually increase emissions from petrol for many years and largely negate the impact on diesel emissions from light vehicles. There is no overall reduction in emissions from petrol until 2025. Even with the delay in the scheme, wholesale petrol suppliers will churn $17 billion in permits over this period. This exposes these suppliers to considerable risk for no environmental gain and provides players in the financial services industry with opportunities for windfall profits.

There is a need for a package of complementary measures to achieve significant emission reductions for motorists and light commercial vehicles, which should accompany their exclusion from the CPRS. Caltex has proposed an integrated package of complementary measures that would establish voluntary carbon efficiency targets for cars and light commercial vehicles to leverage efficiency gains from improvements in overseas technology. The targets would tie in to financial incentives for local manufacturers to produce lower carbon vehicles.

Consumers would be incentivised to achieve the targets by a feebate scheme that provides cashbacks to purchase more efficient vehicles. The package would also include grants for alternative fuels including biofuels and measures to increase public transport use and improve land use planning.

The issues contained in the 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.

2. Carbon Pollution Reduction Scheme Bill 2009

2.1 Upstream point of obligation for liquid petroleum fuel should be removed from legislation while retaining carbon cost for larger emitters from fuels (Part 3)

2.1.1 Policy settings

The CPRS requires liquid fuel suppliers to purchase permits for their customers' greenhouse gas emissions then pass on the cost to customers through fuel prices. This imposes an "upstream point of obligation" for the purchase of permits on suppliers of liquid petroleum fuel from terminals, regardless of whether the fuel is imported or locally manufactured. This permit obligation, which equates to emissions from the fuel once combusted, is quite distinct from the obligation placed on oil refiners for emissions from the operation of their refineries.

Under the CPRS, the Government will cut fuel excise to offset the carbon price impact on fuel prices for many users. The Government will adjust the excise reduction every six months for the first three years (commencing 1 July 2011) based on the average permit price in the preceding six months. The final fuel tax adjustment will take effect, if necessary, on 1 July 2014. <u>This final adjustment will be made permanent.</u>

The excise reduction will reduce the price of petrol for several years because it is based on the carbon intensity of diesel (2.7 kg CO_2/litre of diesel) rather than petrol. This means that emissions from petrol under the CPRS will increase relative to emissions without the CPRS before decreasing as carbon prices exceed the excise reduction.

In relation to diesel, the situation is not as bad (i.e. there is no emissions increase, unlike petrol). There would be no impact on emissions from private motorists and light commercial users for the first three years of the CPRS because the excise reduction will exactly offset the carbon cost. Emissions from diesel will then be reduced more slowly than would be case for the CPRS without an excise reduction. While it is difficult to calculate the emissions impact, an indicative calculation assuming diesel has half the price elasticity of petrol suggests the excise reduction would stifle emission savings from diesel use by motorists, leading to only a 1% cumulative reduction by 2020 compared to an 8% cumulative reduction without the excise offset.[1]

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

For the CPRS-5 price scenario, including the one year transitional arrangements, Caltex calculates that by 2025 cumulative emissions from petrol will be the same as without the CPRS yet petrol suppliers will have purchased $17 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.

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.

2.1.2 Amendment options

The excise reduction means that certain consumers - primarily private motorists and commercial users not eligible for a fuel tax credit - have been effectively removed from the CPRS for many years. The clear policy intention of the White Paper and the practical effect of the CPRS package of legislation is that these consumers will be effectively excluded from CPRS coverage.

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[1] This calculation was made for the original CPRS start date of 1/7/2010 but the outcome would be very similar for the revised 2011 start date.

Caltex therefore proposes the CPRS be amended to remove private motorists and other small consumers from the CPRS and to address the issue of emission reduction from these consumers through complementary measures.

There are various legislative options to achieve this but Caltex advocates either:

- permit liability for emissions for permits to apply only to emissions above the CPRS liability thresholds eg 25,000 tpa for a facility; or
- a carbon cost liability to apply to all consumers receiving a fuel tax credit, which in practice would include all emitters above the CPRS threshold.

In the former case, the liability would be to surrender permits, as for emissions from other sources. In the latter case, the fuel tax credit would effectively be reduced by an amount calculated from historical carbon prices, in exactly the same way as proposed under the CPRS for the "CPRS fuel credit"; this would impose no additional administrative burden on consumers relative to the CPRS.

These options retain the largest or relatively large emitters from petroleum products within the CPRS and are administratively simple and consistent with current CPRS design.

2.1.3 Recommendation

Caltex recommends the CPRS legislation be amended in accordance with either Option 1 or Option 2 below.

Option 1: include fuel users above CPRS threshold

Fuel users with activities that emit greenhouse gas emissions above the CPRS threshold (eg 25,000 tpa carbon dioxide equivalent for a facility) are required to report these emissions under NGERS, including emissions from petroleum products. Under the CPRS, there is an upstream point of obligation that requires fuel suppliers to purchase permits on behalf of customers. However, the CPRS provides an Obligation Transfer Number (OTN) mechanism to allow consumers of petroleum products to take on the permit liability for emissions from these fuels.

Over time, the Government contemplates moving from a voluntary liability for large emitters (via the OTN) to a mandatory liability, subject to business systems being developed by suppliers to differentiate between large users (with their own liability) and other users (for which suppliers would retain an upstream point of obligation.) It would be consistent with the philosophy of the CPRS that large end users take on liability for petroleum product emissions, as for other emissions. Under Caltex's proposal, this could occur immediately as there would be no upstream point of obligation for fuel suppliers so no requirement for the development of business systems by fuel suppliers.

Under this option, petroleum product users below the CPRS threshold would not have any permit liability nor would product suppliers. Emission reduction for these emitters would be managed through complementary measures.

One criticism of such a proposal could be the potential for businesses above the threshold to restructure their operations so as to avoid permit liability. This could be tackled in various ways: through rules relating to the emissions of related entities; by extension of the carbon liability to smaller emitters through option 2 below; or through the anti-avoidance provisions in the CPRS legislation.

The specific changes to the legislation should be:

- delete sections 31 and 32 - this removes the upstream point of obligation for liquid petroleum fuel
- delete sections 18(9) and 18(10) - this removes the "no double counting" provisions for liquid petroleum fuel, thereby making users of liquid petroleum fuel who exceed the CPRS thresholds liable for purchase of emission permits
- not proceed with the *Excise Tariff Amendment (Carbon Pollution Reduction Scheme) Bill 2009* and *Customs Tariff Amendment (Carbon Pollution Reduction Scheme) Bill 2009* - this removes the excise reduction as it is no longer necessary because fuel prices will not be increased by the cost of carbon.

Note that regulations made pursuant to s24 would ensure the emissions were correctly calculated for fuel users who would become liable for emissions from their use of liquid petroleum fuel.

Option 2: include all fuel users eligible for a fuel tax credit

The fuel tax credit scheme provides credits of up to 38.143 cpl for various types of fuel users. The maximum rate of 38.143 cpl applies to all taxable fuels including petrol and diesel used in agriculture, fishing, forestry, mining, marine transport, rail transport, nursing and medical businesses and electricity generation. A fuel tax credit of 19.07 cpl applies to construction, manufacturing, wholesale/retail, property management and landscaping until 1 July 2012, when the full 38.143 cpl credit applies. A credit of 17.143 cpl applies to vehicles above 4.5 tonnes gross vehicle mass travelling on public roads and using any taxable fuel including petrol and diesel.

Under the Government's CPRS proposals, these fuel tax credits would be reduced by an amount equal to the reduction in excise. For example, if the general rate of excise was reduced from 38.143 cpl to 28.143 cpl as a result of a 10 cpl carbon cost, the maximum fuel tax credit would also be reduced to 28.143 cpl. Eligible fuel users would still effectively pay zero excise but would face a 10 cpl increase in fuel prices due to the carbon cost. For this reason, under the CPRS, a "CPRS fuel credit" will be paid to certain users in the above categories for one to three years to offset the impact of carbon prices on fuel costs (see CPRS White Paper p17-17).

Under Caltex's Option 2, there would be no general increase in fuel costs as there would be no liability for fuel suppliers to purchase permits for customers' emissions. However, fuel tax credits would effectively be reduced by an amount equal to the cost of carbon, thereby imposing a carbon cost on all fuel users eligible for a fuel tax credit, which aligns with the Government's White Paper policy and the 4 May update.

The effective reduction in fuel tax credits under Caltex Option 2 above would be calculated and adjusted periodically in exactly the same way as the CPRS fuel credits i.e. on the average of auction prices over the previous six month period; at the same time, the general fuel tax credit rate would be reduced by the same amount.

The specific changes to the legislation should be:

- delete sections 31(2) to (5) and 32(2) to (5) - this removes the upstream point of obligation for liquid petroleum fuel but retains the definitions required by sections 18(9) and 18(10)
- retain sections 18(9) and 18(10) - this retains the "no double counting" provisions for liquid petroleum fuel, thereby making users of liquid petroleum fuel not liable for purchase of emission permits
- amend the *Excise Tariff Amendment (Carbon Pollution Reduction Scheme) Bill 2009* and *Customs Tariff Amendment (Carbon Pollution Reduction Scheme) Bill 2009* so that the **fuel tax credit** is reduced rather than the **rate of excise -** the carbon cost linking mechanism would be unchanged.
- not proceed with the *Customs Tariff Amendment (Carbon Pollution Reduction Scheme) Bill 2009* as the rate of customs duty is not being reduced.
- retain the *Carbon Pollution Reduction Scheme (CPRS Fuel Credits) Bill 2009* - this provides transitional assistance to offset the impact of the reduction in the fuel tax credit, in accordance with the Government's policy position.

The following table illustrates how the Caltex proposal would work for private motorists and heavy vehicles. The illustration is for diesel but would apply in the same way to petrol.

(All figures are cpl)	Private motorists without CPRS	Private motorists under CPRS	Private motorists under Caltex proposal	Heavy vehicles without CPRS	Heavy vehicles under CPRS	Heavy vehicles under Caltex proposal
Fuel price	120	120	120	120	120	120
plus carbon cost	0	10	0	0	10	0
Subtotal	120	130	120	120	130	120
less excise reduction	0	10	0	0	10	0
Subtotal	120	120	120	120	120	120
less fuel tax credit	0	0	0	17	7	7
less CPRS fuel credit	0	0	0	0	10*/0	10*/0
Net price	120	120	120	103	103*/113	103*/113

All figures are in cents per litre, example is for diesel (i.e. excise reduction equals carbon price)
* CPRS fuel credit of 10cpl in 2011-12 only

(All figures are cpl)	Agriculture and fishing without CPRS	Agriculture and fishing under CPRS	Agriculture and fishing under Caltex proposal	Other diesel users e.g. mining without CPRS	Other diesel users e.g. mining vehicles under CPRS	Other diesel users e.g. mining vehicles under Caltex proposal
Fuel price	120	120	120	120	120	120
plus carbon cost	0	10	0	0	10	0
Subtotal	120	130	120	120	130	120
less excise reduction	0	0	0	0	10	0
Subtotal	120	120	120	120	120	120
less fuel tax credit	38	28	28	38	28	28
less CPRS fuel credit	0	10*/0	10*/0	0	0	0
Net price	82	82/92	120	82	92	92

*Carbon cost in first year of CPRS will be fixed at 2.455cpl. The figure of 10cpl is for illustration only in subsequent years.

2.2 Major administrative issues relating to obligation transfer numbers must be resolved (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.

2.2.1 OTN regulation should be clarified

Issue

The Authority has 90 days to determine an application for an OTN and the basis for refusal is not known. In addition, the fee payable is yet to be confirmed and clarity regarding the application of the OTN for subsidiary businesses is required.

Recommendation

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.

2.2.2 Suppliers should not be required to check customers' OTNs for each transaction

Issue

The cancellation or surrender of an OTN will need to be communicated in a timely fashion as only a 7 day grace period is provided for supplies made under a standing quotation of a subsequently cancelled or surrendered OTN. While the inclusion of this grace period under Clauses 51F and 51G is welcomed it does not fully address our concerns with regard to the 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

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 or when a standing order is accepted by the supplier.

2.2.3 Obligation should be on customer to notify change in OTN status

Issue

Section 51C gives the OTN holder the option as to whether it gives the supplier written notice of withdrawal of a standing quotation of the OTN. Where the OTN holder is no longer permitted to use its OTN in relation to the supply and its does not notify the supplier, the burden remains upon the supplier to confirm validity of the OTN quotation or it could be exposed to penalties relating to its involvement in the use of a bogus OTN or misuse of an OTN. Section 51C does not require the supplier's agreement to the withdrawal of the standing quotation in the event that the OTN holder is no longer required to quote the OTN holder's OTN in relation to those supplies. Unless the OTN holder is no longer permitted to quote its OTN in relation to those supplies, the OTN holder should require the supplier's agreement before withdrawing a standing quotation.

Recommendation

1. Amend Clause 51BA to include a provision that the OTN holder **must** provide written notice of withdrawal of a standing quotation of the person's OTN to the supplier in the event that their OTN is cancelled or surrendered.

2. Amend Clause 51C to include a provision that the OTN holder **must** provide written notice of withdrawal of a standing quotation of the person's OTN to the supplier in the event that they are no longer **permitted** to quote the OTN in relation to those supplies.

3. Amend Clause 51C such that the withdrawal of the standing quotation requires the supplier's agreement in the case where the OTN holder is no longer required to quote the OTN in relation to those supplies.

4. 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.

2.3 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 required number of permits at each auction or risk being unable to secure sufficient permits at subsequent auctions because of the parcel size limit. This risk may increase over time as the carbon liability increases (due to growth in use of liquid fuels) and the permits at auction decrease with a tightening national emissions cap. In addition, the requirement to bid for large quantities of permits at most or all auctions will potentially raise the price we will need to pay. Permits may be acquired on the secondary market but the operation and pricing of this market is entirely unknown.

Without certainty as to the structure and regulatory requirements in relation to the auction system, business is not able to plan adequately. Caltex's submission on deferred payment arrangements for the CPRS auction (appendix 2) provides further detail.

Recommendation

1. The parcel size limit should be increased to 50% for liable entities subject to an annual permit liability in excess of 20 million tonnes.

2. Regulations relating to procedures, policies and the rules for auctioning need to be made available so that a comprehensive and informed view of the bill can be formed before it is debated.

2.4 Regulations relating to non-Kyoto international emission units should be brought forward (Division 4)

The detail relating to non-Kyoto emission units is not yet available. However 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.

2.5 Later vintages should be available to meet permit obligations (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 preceding 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

The legislation be amended so that there be no restriction on which future vintages an organisation can draw upon for its borrowing limit.

2.6 Emissions-intensive trade-exposed (EITE) assistance program should be incorporated in bills to greater extent and any remaining regulations tabled with bills (Part 8, Division 1-3)

There are no regulations covering the EITE assistance program for consideration in conjunction with the bills. It is not possible to assess the impact of the CPRS with the limited information available on eligibility, quantum or administrative issues. The legislation fails to provide certainty.

Regulations are 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. There will be no mechanism for scrutiny of DCC decisions or appeals against them. This process means that the crucial EITE permit eligibility rates and activity definitions 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.

In addition, the Parliament should be able to debate and if neccesary amend the EITE assistance rates and thresholds.

2.7 Emissions-intensive trade-exposed (EITE) assistance program should ensure full maintenance of international competitiveness (Part 8, Division 1-3)

Caltex's two oil refineries will emit in total about 2.5 million tonnes of carbon dioxide equivalent ($MtCO_2e$) annually when the CPRS is in operation. At the CPRS-5 price scenario, once full trading commences, this will result in a permit cost of about $25 million pa in the early years of the scheme, increasing to about $35 million (in $2005) by 2020. At the CPRS capped price, the permit costs would be $40 million pa and $60 million respectively. These figures assume a nominal rate of 60% free permits and 1.3% pa carbon productivity contribution reduction.

These permit costs will not be recoverable because the prices of petroleum products from Caltex's refineries are based on import parity and none of the overseas refineries that are our direct competitors (eg in Singapore and Korea) seem likely to adopt equivalent carbon costs for the foreseeable future. This makes the CPRS a tax on competitiveness instead of an incentive for emission reduction.

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 outlook for oil refining is adding to our concerns. 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 over Australian refineries including being closer to growing markets. This means no new refineries will be built in Australia and imports will accordingly increase.

Caltex believes international competitiveness must be fully maintained, which means 100 per cent free allocation of permits must be provided for in the scheme. Until overseas refineries such as those in Singapore which supply product to Australia bear equivalent carbon costs, the free 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 such a policy (100 per cent free allocation of permits) threatens to destroy Australian investment and jobs without reducing global emissions.

At this stage it is expected that only 60 per cent of the permits required to cover these emissions will be free. Having to purchase 40 per cent of permits would seriously reduce the funds needed to keep Caltex's refineries running reliably and efficiently. The proposed Global Recession Buffer will reduce the CPRS productivity tax from a nominal rate of 40% to 34% for five years. The Buffer therefore does little to cut the burden in the first five years and nothing in the longer term. 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 are not recoverable from customers.

Refineries already consume large amounts of energy so focus closely on energy efficiency. As a result, there is not much scope to reduce greenhouse gas emissions through better efficiency.

The Australian Institute of Petroleum says the CPRS could place significant pressure on the viability of a number of Australian refineries over the period to 2020 and may lead to closures. Caltex agrees with this assessment. Yet 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. A supply chain is not strengthened by removing some of the links.

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

The *Carbon Pollution Reduction Scheme Bill 2009* should be amended to provide for 100 per cent permit allocation to EITE industries until international competitors face the same carbon costs.

2.8 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

Amend the legislation to raise the limit of notification of significant holding to 20 per cent or apply a scale of notification requirements related to permit liability such that notification limits are greater than permit liabilities. This level of holding is more likely to signal behaviours associated with market manipulation as it is in excess of any individual entity’s liability.

2.9 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 and 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*, 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. Caltex's submission to the eligible emissions units as financial products issues paper (appendix 2) provides further detail.

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 2011 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 ccustomer 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 – Schedule 2, item 19, sections 420-50 to 420-57

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 three methods: the FIFO cost method; the cost method; or the market value method. Effectively, the FIFO and actual cost methods are the same. Companies may elect to vary the method only once during the transition period (up to 2016). Thereafter, companies will be allowed to vary the method only after it has adopted the same method for the previous four years.

This so called relaxation of the choices is to enable companies to "respond to changing business circumstances whilst limiting opportunity for tax arbitrage." Business cannot and should not have to wait up to four years in order to rapidly respond to a changing economic environment. Any added financial cost associated with adverse tax positions adopted would exacerbate the financial position of entities such as Caltex, who are exposed to substantial liability as a fuel producer.

If the Government is concerned about tax arbitrage, then the anti-avoidance provisions may be used to limit any such benefit arising in the absence of external economic drivers. Business does not have the luxury to wait four years before it can respond.

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

Recommendation

The legislation be amended so that companies can be given an opportunity to elect which tax valuation methodology they adopt on a year to year basis to enable them to respond to changing economic conditions.

3.5 Application of GST – Schedule 2, item 1, section 9-10 of the GST Act 1999

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

The legislation be amended so that the trading of permits and the associated derivative products 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.

3.7 Company PAYG Instalments - Schedule 2, item 51, subsection 45-120(5) of the TAA 1953

Under the proposed provisions of sub-sec 45-120(5) of the *Taxation Administration Act*, the value of the emission units purchased and incorporated into the price of goods and services will be included in the company's instalment income. As an upstream liable entity, Caltex will be required to include the value of permits in the price of fuel, thereby increasing the instalment income upon which its quarterly tax liability is computed. Although companies have the option of varying their PAYG instalments, a significant penalty risk exists if the estimate varies by more than 15% from the actual.

When the added financing cost for prepaid tax, GST and the non-deductibility of the cost of emission units a significant financial burden is placed on Caltex and the oil industry.

Recommendation

Allow additional flexibility to the Commissioner of Taxation, at least during the transition period, for companies such as Caltex to vary their PAYG instalments without risk of penalties. Any interest charge imposed should be limited to the SIC ("Shortfall Interest Charge").

Appendix 1

CALTEX

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6 May 2009

Mr Alan Hopkins
Carbon Markets Section
Emissions Trading Division
Department of Climate Change
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Canberra ACT 2601

CPRS_auctions@climatechange.gov.au

Dear Mr Hopkins

Re – Deferred payment arrangements for the Carbon Pollution Reduction Scheme auction

Caltex Australia Limited welcomes the opportunity to comment on the discussion paper outlining issues associated with Government provision of deferred payment arrangements at the CPRS auction. 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.

Deferred payment arrangements would allow successful bidders to make final payments for permits over some specified time period and would reduce the impact on industry cash flows that would arise from immediate settlement. The CPRS has the potential to greatly increase business debt, risk and cost. Caltex's comments on the discussion paper identify a number of shortcomings with the proposed design and outlines options to mitigate these negative impacts.

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 additional 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 the major maintenance projects that are required regularly in all oil refineries.

Stakeholder Feedback Request Number 1

Please provide any comments regarding the development of the Australian or foreign markets for AEUs and whether financial service providers have the ability to provide deferred payment in the absence of Government intervention.

The key issue is not the ability of financial service providers to provide for deferred payment but the cost of doing so and the balance sheet implications. The imposition of an upstream point of obligation requires companies to finance the purchase of permits through increased debt or possibly an equivalent financial liability. This is not only disproportionately costly relative to the cost of a company's own emission permits but may be difficult to arrange, particularly when economic conditions are poor and credit is tight. By providing deferred payment for current permit vintages, this impost could be substantially reduced.

Stakeholder Feedback Request Number 2

Please provide comments on whether the advantages and disadvantages of deferred payment provided by Government have been adequately captured.

The potential benefits of the deferred payment arrangements were set out in relation to the auction of future vintages only. However, there would be substantial benefits from deferred payment arrangements in relation to current vintages as discussed above.

The first benefit outlined in Section 1.3 is that 'deferred payment allows cash constrained bidders to more easily participate in future vintage auctions'.

An example provided in Section 1.5 outlined that final payment for a 2012 permit would be due on or before 25 June 2011, that is 18 months in advance of the surrender date. This payment timing provides limited cashflow benefit.

If the above circumstances are changed to purchasing 2014 vintage permits in 2010, a non-refundable deposit (which is yet to be quantified by the Government and may be substantial) will be paid in 2010 being four years in advance of the surrender date. The balance of the 2014 vintage permits will be paid in June 2013, 18 months in advance of the surrender date. This provides limited working capital or cashflow benefits for purchases of future vintage permits, due to the requirement to pay so far in advance of earning revenue for the activity generating the emissions.

Additionally, for income tax purposes companies are currently able to immediately deduct legally incurred liabilities in the tax reporting year. Under the CPRS, the cost of AEUs on hand at year end is not recognised as an immediately deductible liability unless the permit has been sold or surrendered to the Government. This is inconsistent with the treatment of other costs.

In the above example, Caltex would be required to bear the burden of paying the deposit in one year, three years later paying the balance of the AEU cost and only in the subsequent year (2014) being able to claim the deduction. This would impact cash flow and financing costs including interest.

Caltex proposes closer alignment of the deferred payment date with the surrender date so that revenue inflows could be aligned with the timing of expenditure. Similarly, the deposit and the final payment of the AEU should be able to be deducted in the tax reporting year in which the expense was incurred.

The second benefit outlined in the discussion paper was that the deferred payment arrangements would be likely to encourage participation at auction. Caltex is of the view that the deferred payment arrangements, as proposed, would not encourage participation at the auctions as the working capital and cash requirements are not significantly improved through the proposed arrangements. It is also difficult to identify the benefits to small to medium enterprises.

Stakeholder Feedback Request Number 3

Please provide comments on the appropriateness of deferred payment and the options put forward.

The deferred payment arrangement discussion paper does not contemplate the option of deferred payment for current vintage permits. Caltex believes this is a serious deficiency in CPRS policy.

Whilst the White Paper stated a position that liable entities will have ample opportunity to manage their permit purchases in line with their revenue flow, liable entities with upstream liability such as Caltex will be required to secure permits throughout the year from most if not all auctions in order to fully meet their liabilities.

Depending on permit price, the average monthly expenditure on permit price could be in the order of $100M per month, and as per Section 1.2.3 will be required to be paid within a few days of auction close.

The chart below shows the historical Caltex peak debt compared with debt facilities ie the borrowing limit. Introducing $100M per month additional debt would significantly reduce the ability of Caltex to maintain headroom against debt facilities should the payment be due at the highest debt commitment time. This headroom is required to maintain a prudent financial position and meet the requirements of lenders.

Caltex proposes an alternative payment arrangement based on monthly auctions, with weekly settlements for one quarter of the permits purchased. However, the weekly settlement should not occur on Mondays, which are the business days when excise is due to be paid. This would minimise working capital and cashflow impacts on affected upstream fuel suppliers.

Yours sincerely

Frank Topham
Manager Government Affairs & Media

Appendix 2

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6 May 2009

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Department of Climate Change
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Dear Ms Smith,

Re – Eligible Emissions Units as Financial Products – Issues Paper

Caltex Australia Limited welcomes the opportunity to comment on the Issues Paper regarding Eligible Emissions Units (EEUs) as Financial Products. Because Caltex must purchase permits for its customers' emissions as well as its own emissions, it will be Australia's largest single compliance purchaser of emission permits so has a vital interest in the effectiveness of the "financial product" regime.

The Government has decided that EEUs under the Carbon Pollution Reduction Scheme will be financial products for the purpose of the *Corporations Act 2001* and the *Australian Securities and Investments Commission Act 2001*.

As no other similar international scheme has classed its permits as financial products the Government's decision could impact the ability of Australia to develop international linkages and trade in international permits.

The treatment of EEUs as financial products also introduces significant regulatory, legal compliance and consequently cost issues to participating entities.

Entities wishing to trade permits and participate in auctions directly without a broker or a financial intermediary will need to hold a financial services licence. Whilst Corporations Regulation 7.6.01(1)(m) provides amongst other things, that a financial service provided by a person in certain circumstances is exempt from the need for an Australian financial services licence, the exempt circumstances only extend to dealings entered into on the "person's own behalf".

Accordingly, it does not extend to allow an entity in the corporate group structure to purchase EEUs on behalf of another entity in the corporate group or on behalf of a customer.

This has the impact of restricting liable organisations' ability to manage their permit liabilities 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.

By classifying EEUs as financial products, Chapter 7 of the Corporations Act is introduced to address a range of market misconduct and other prohibited conduct relating to the financial products and financial services. Caltex recognises and supports the requirement to ensure transactions in EEUs are protected from market misconduct and manipulation. However, should the EEUs be classed as a commodity Caltex is of the view the Government has other options to protect against this type of behaviour. The Government has the opportunity to provide this protection through how they set the auction regulations and rules. The *Trade Practices Act 1974* would also provide further protection against market misconduct and manipulation related to the permit transactions.

Recommendation

The CPRS should treat EEUs 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 to deal in EEUs. It is possible to regulate against market manipulation through proposed provisions such as parcel size restriction and notification of holdings, auction rules and the provisions of existing legislation.

Alternatively, if EEUs are to remain as a financial product, the *Corporations Act 2001* and the *Australian Securities and Investments Commission Act 2001* should be amended to reflect the ability for any entity in a corporate group structure to trade on behalf of another corporate group entity, thereby removing the requirement to hold a financial services licence.