

PUTTING TEETH INTO THE SAFEGUARD MECHANISM: CONSULTATION PAPER ON PROPOSED CHANGES RELEASED

The Australian Federal Government is calling for submissions on its proposed changes to the Safeguard Mechanism. Significant impacts are expected for industry, as emissions baselines will be consistently lowered and a carbon credit trading scheme introduced.

What could the proposed changes mean for business?

The proposed changes to the Safeguard Mechanism are relevant to many sectors of the business community.

1. All businesses should be aware that the proposed changes are just the first part of the consultation and be alert to related legislative and policy changes that may have impacts across its business more broadly.
2. Emitters are clearly the most directly affected and will need to consider whether the proposed amendments to the Safeguard Mechanism impact the economic viability of existing or proposed projects.
3. Participants in the carbon market will also need to be alive to the potential introduction of a new type of carbon credit, Safeguard Mechanism Credits, and the proposed ability to trade these credits in Australia.
4. Developers of clean energy technologies may be able to capitalise on more emitters facing the need to make steep cuts in their emissions in order to meet their baselines.
5. Investors are being called upon to monitor the conduct of companies and industry associations throughout the consultation process, in particular as to whether their positions on the proposed changes align with their net-zero pledges and green ambitions.

Overview

The Australian Federal Government is calling for submissions on its proposed changes to the Safeguard Mechanism. Since 2016, the Safeguard Mechanism has been used as a legislated framework to limit the scope 1 emissions of ~215 Australian facilities. It imposes 'baseline' emissions, which facilities cannot exceed unless they use offsets. The Safeguard Mechanism applies to facilities that emit more than 100,000 tonnes of CO₂ equivalent per year. This includes power companies, airlines, coal mines, smelters, cement producers and manufacturing.

The key matters submissions are being sought on are:

- How baselines for existing facilities covered by the mechanism should be set – in particular whether they should be fixed or 'production adjusted'.
- Whether 'headroom', which effectively allows emitters to exceed baselines without penalty, should be immediately removed.
- What method should be used to set baselines for new facilities, particularly whether it should be modelled off 'best practice' or an industry average.
- How the introduction of Safeguard Mechanism Credits should work. This change is expected to lead to a carbon credit trading scheme, that may also overlap with Australia's existing carbon market.
- Whether there should be tailored treatment for emissions-intensive trade-exposed businesses in the form of more lenient baselines or additional funding for the implementation of clean energy technologies.

Why are changes to the Safeguard Mechanism being proposed

There are a number of reasons why the Safeguard Mechanism is proposed to be amended.

1. To achieve soon to be legislated emissions reduction targets

The proposed changes to the Safeguard Mechanism a key piece needed to achieve the Federal government's 2030 and 2050 emissions reduction targets. These targets are expected to be legislated next month. Facilities covered by the Safeguard Mechanism produced 28% of national emissions in 2020-21, so legislating emissions reductions is crucial to meeting the targets.

2. To address criticism that the existing mechanism is ineffective

The Safeguard Mechanism has been criticised for being ineffective due to the leeway that it has given emitters to exceed their baselines without penalty. Cumulatively, this has led to facilities emitting nearly 33% more than their allowable baseline emissions. The Federal Minister for Climate and Energy acknowledged this saying "... the safeguards, have failed and emissions have gone up from facilities covered by the safeguard mechanism".¹

3. To insulate Australia against global energy transition risks

From an economic perspective, requiring the reduction of emissions may help to protect Australian businesses against global energy transition risks. These include trade measures, such as the proposed Carbon Border Adjustment Mechanism (CBAM). Similar measures are also being considered by the UK and Japan. These trade measures may impose taxes on Australian products which have high embodied carbon content, thereby making products produced in a less emissions intensive ways more attractive. If adopted, the CBAM would affect Australian exports of aluminium, steel, cement, glass, paper and heavy chemicals into the EU.

4. To promote investment in clean energy technology

Lastly, the proposed changes to the Safeguard Mechanism strengthen the message to investors that Australia is serious about acting on climate change and is open to new technology that will help industries to decarbonise. We commented on the signal that is being sent to investors, both domestic and abroad, in this recent article.

What matters are being consulted on

The questions posed by the consultation paper are many and diverse. Critical changes to the mechanism, which feedback is being sought on include:

1. How should baselines be set for existing facilities?

The consultation paper questions whether baselines should be 'fixed' or 'production adjusted'. Australia is currently operating on a 'production adjusted' framework. This allows baselines to adjust each year based on production. Baselines are recalculated each year based on production volumes of a product or service multiplied by the emissions intensity of that production. The effect of this is that it rewards businesses that achieve lower emissions intensity by allowing increased production and output. This is the framework that the consultation paper is more strongly in favour of.

Comparatively, fixed baselines simply place an absolute limit on emissions. These fixed baselines would then be reduced year by year. The consultation paper explains that this is a simpler approach but acknowledges that it may lead to businesses reducing their domestic production to meet baselines. This is arguably not a good economic outcome and may lead to the stalling of clean technology developments.

2. Should 'headroom' be removed from the mechanism?

The current framework allows for emissions to be calculated in a way which provides 'headroom'. Put simply, 'headroom' is the gap between baseline values and lower reported emissions. The effect of 'headroom' is that facilities have been able to report emissions above their emissions baselines. For example, the carbon consultancy group RepuTex found that 'headroom' allowed emissions of up to 32% more than the baselines without penalty.

The consultation paper strongly argues in favour of removing headroom. This is firstly because it will require real emissions reductions from emitters. Secondly, it notes that "Second, crediting and trading, which are important to help businesses manage their compliance costs, cannot commence until there is scarcity in the market—that is, aggregate baselines must be below aggregate emissions—or no abatement will occur."

3. How should baselines for new facilities be set?

The threshold of 100,000 tonnes of CO₂ equivalent which triggers the application of the Safeguard Mechanism is not being changed. However, a matter for discussion is the process for baseline setting for new facilities. Two options are being considered. The first suggestion is to follow best practice and set baselines for new entrants based on the average emissions intensity of the top 10% of Australian industry performance. The argument in favour of this method is that it recognises the ability of new entrant to utilise the latest low emissions technology. Further, they have the opportunity to build lower emissions approaches into their design from the outset.

The alternative is to set baselines using an industry average i.e. consistent with the current framework. The argument in favour of an industry average approach is that all facilities are placed on an equal playing field. The incentive to reduce emissions more dramatically than other facilities would come through the availability of credits.

¹ <https://thewest.com.au/news/environment/climate-change-bill-hearings-to-begin-c-7918636>

4. Introduction of Safeguard Mechanism Credits

The introduction of a new form of carbon credit would include a 'carrot and stick' approach in the Safeguard Mechanism. The proposal is for facilities that achieve emissions below their baselines to be rewarded with tradeable Safeguard Mechanism Credits (**SMCs**). These credits can be sold to other facilities that exceed their baselines and need to 'offset' in order to meet their compliance obligations. It is proposed that facilities could also 'bank' SMCs for compliance in future years.

SMCs may also continue to be issued to facilities which fall before the 100,000-tonne threshold for the Safeguard Mechanism. This could incentivise further emissions reductions, with reporting and crediting being carried out under the National Greenhouse and Energy Reporting Scheme (**NGERS**). It is proposed that trading could commence as 1 July 2023, subject to the passage of necessary legislative amendments. A further consideration is that the proposed changes not inadvertently "rewarding" historically poorly performing facilities by issuing SMCs, even though until now they have not taken steps to reduce their emissions

5. Interaction with the existing Australian carbon market

The consultation paper suggests that flexibility for facilities to use Australian Carbon Credit Units to meet their baselines should be retained. However, this could result in the lower value of SMCs. A further consideration is whether facilities could also continue to generate Australian Carbon Credit Units (ACCUs). This is because facilities who are effectively forced to reduce their emissions to meet lowering baselines are no longer meeting the 'additionality principle'. The additionality principle requires an emitter to show that they are going beyond existing legal requirements in order to receive ACCUs. It is likely that these considerations will be weighed up in light of the current 6-month Chubb review into the integrity of ACCUs.

6. Should there be tailored treatment for emissions-intensive trade exposed (EITE) businesses?

This question is posed to ensure that Australian businesses are not disadvantaged on the international market. There may be a risk that by requiring Australian businesses to reduce their emissions intensity their products become more expensive to international buyer. Comparative products from countries with less rigorous emissions regulations may therefore be more competitive.

Whether more lenient baselines should be set for EITE businesses should be weighed up against whether global competitors already face similar carbon costs. If so, then the argument for more lenient baselines falls away. Further, as noted above, the introduction of more lenient baselines may also result in adverse effects if measures such as the CBAM come into effect. Ultimately, it may also lead to less drastic emissions reductions by EITE businesses. A potential compromise that has been suggested would be to provide funding for low emissions technologies, rather than allowing more lenient baselines. Whether the Federal government should be making this funding available to highly profitable private businesses is another question.

What businesses should look out for

All businesses

Businesses should be aware that this is only the first round of consultation. Further feedback including on proposed changes to the Safeguard Mechanism Rule will be sought later this year. In the same vein, businesses should be alert to any legislative and policy changes that are linked to the Safeguard Mechanism and that may have impacts across its business more broadly. Example of this include the outcomes of the Chubb review into the integrity of ACCUs, the implementation of trade rules such as the CBAM and possible changes to the NGERS.

Emitters

Emitters will of course be watching the developments closely. It will be particularly interesting to see what effect the proposed changes will have on the development of new projects with hard-to-abate emissions. These projects may either be shelved if the requirement to consistently reduce emissions is unattainable.

Alternatively, depending on the price of SMCs (and possibly ACCUs), the cost of offsetting above baseline emissions may make project less economically viable. It is also possible that major coal and gas projects will face a further uphill battle, as the Greens have announced that they will use their balance of power position in parliament more assertively to call for a halt on new coal and gas projects. This is on the basis that other sectors, such as manufacturing, will have to do more of the heavy lifting to reduce emissions and help Australia meet its emissions reduction targets.²

Businesses dealing in ACCUs

For businesses that currently deal in ACCUs, the announcement of a credit trading scheme is the biggest proposed change to be aware of. Whether ACCUs remain available for covered facilities to meet their baselines is likely to have an effect on demand, particularly if annual emissions reductions are set closer to the foreshadowed 6%. The timing of a credit trading scheme will be dependent on how quickly baselines are changed and whether headroom is removed. Until emitters are required to drive emissions below lower baselines, there will be less demand for SMCs

² <https://www.theguardian.com/environment/2022/aug/18/greens-signal-fresh-fight-over-fossil-fuels-as-labor-revamps-safeguard-mechanism-to-cut-industrial-emissions>

and ACCUs. The consultation paper suggests that if current baselines and headroom are retained, then crediting and trading may not commence until 2026-27.

Developers of clean energy technologies

The winners in this scenario are of course developers of clean energy technologies. If drastic emissions cuts are required as a result of the proposed changes, then emitters are likely to be looking at all options available to help them 'meet and beat' their baselines. This is especially the case if the Federal government makes funding available to EITE's for investment in low emissions technologies. However, recommendations have been made that funding should be time-limited so as to not undermine the long-term energy transition vision. EITE's and other emitters' ambitions are expecting to scale up over time, and not necessarily at the taxpayers' expense.

Investors

Investors have been called upon to monitor the conduct of companies and industry associations throughout the consultation process and as the mechanism is re-designed. This is because of fears that companies that have made net zero pledges, may be lobbying against a robust Safeguard Mechanism that will force significant emissions cuts in the near future.³

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³ <https://www.accr.org.au/news/safeguard-mechanism-consultation-will-be-feeding-frenzy-for-industry-lobby/>