Examining the Implications of Australian Interpretation 21 *Levies* for the Fixed Price Phase of the Carbon Pricing Mechanism

Introduction

1. IFRIC 21 *Levies* (paragraph 6) scopes out liabilities that arise from emissions trading schemes (ETSs) and notes that:

   > *"The IASB decided in 2011 to add a project on this topic to its research agenda. The Interpretations Committee thinks that it would be better to address the accounting for liabilities that arise from emissions trading schemes in a comprehensive project on all recognition and measurement issues related to emissions trading schemes*."
   > (paragraph BC9)

2. IFRIC 3 *Emission Rights* was issued by the IASB in 2004 and was withdrawn in 2005 pursuant to comments received from some constituents that it created unsatisfactory measurement and reporting mismatches. Accordingly, the issue of accounting for emission trading schemes was referred to the IASB. After deliberations by the IASB, it was decided that a research project be added to its agenda to consider the issue of accounting for emissions trading schemes.

3. Whether the fixed price phase of the carbon pricing mechanism (CPM) – also known as carbon tax – is within the scope of Australian Interpretation 21 is a matter of judgement. The IFRIC's decision to scope out emission trading schemes (ETS) in IFRIC 21 was consistent with a previous decision to transfer the discussion of the issue to the IASB when IFRIC 3 was withdrawn.

4. The fixed price phase of the CPM exhibits some similarities with ETSs such as the tradability of some carbon units such as free permits. However, not all carbon units are tradable under the fixed price phase of the CPM. There are also fixed price permits that can be purchased by emitters without any limit. There is a cap on emissions under a cap and trade ETS while under the fixed price phase of CPM, there is no cap and entities would be able to emit so far as they surrender permits in respect of those emissions. The availability of purchased permits would also mean that the some of the measurement mismatches that led to the withdrawal of IFRIC 3 might not pose a significant problem in the case of fixed price phase of the CPM.

5. Staff are of the view that a scope decision in relation to the fixed price phase of the CPM based on comparing its features with an ETS would be a matter of judgement. Some would argue that, given the Board's policy on IFRS adoption and not issuing AASB-only Interpretations, it would be inappropriate to opine on that matter which would be tantamount to interpreting the Interpretation[1]. Therefore, the purpose of this paper is not to determine whether the fixed price phase of CPM is within the scope of the Interpretation. However, as Australian Interpretation 21 is part of the Australian Accounting Standards, examining its applicability in terms of its implications and usefulness in the context of relevant legislative and regulatory requirements would help clarify the extent to which the Interpretation would enhance the application of AASB 137 in the context of the Australian fixed price phase of CPM. Accordingly this paper is prepared on the assumption that Australian Interpretation 21's scoping out of ETSs does not apply to Australian fixed price phase of the CPM.

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1 However, we acknowledge there is some precedent for the AASB issuing that kind of Interpretation – Interpretation 1003 *Australian Petroleum Resource Rent Tax*..

Background

6. The Clean energy Act (CEA) was enacted in November 2011. The legislation establishes the framework for a CPM with two phases; a fixed price phase in which permits (referred to in the law as carbon units) have a fixed price set by the Government; and a flexible price phase in which permits can be traded.

7. The fixed price phase of the CPM began on 1 July 2012 and is applicable until 30 June 2015. From 1 July 2012**,** entities with emissions exceeding 25,000 tonnes of carbon dioxide equivalent (CO_2-e) are required to pay a carbon tax by surrendering one permit for every tonne of CO_2-e emitted in a relevant compliance year. The price of a permit for the first compliance year (2012-2013) is set at $23, with the price to be increased in real terms annually by 2.5% until 2015. In some cases, such as emissions from certain landfills, other thresholds set by the legislation may become applicable.

8. During the fixed price phase of the CPM the Government 'sells' permits to emitters as the means of settling the emitter's emission obligations. There is no cap on the number of permits that can be purchased from the Government by emitters. Significant compensation is provided to entities in emissions-intensive trade-exposed industries and others through the issuance of free permits and other means.

9. The emissions data used under the CPM builds on the reporting framework created under the *National Greenhouse and Energy Reporting Act 2007* (NGER Act). Under the NGER Act, liable entities must report their final assessment of their emissions to the Clean Energy Regulator (CER), at the latest by 31 October after the compliance year. However, during the fixed price phase, most liable entities should report an 'interim emission number', and surrender permits in respect of their interim emissions before 15 June in the compliance year (these are generally entities that emit more than 35000 tonnes of CO_2 –e per year). The interim emission number is calculated as 75% of the entity's total Provisional Emission Number (PEN)[2] for the previous compliance year. The entity may, however, use the PEN for the current compliance year for calculation of interim emissions if it constitutes a reasonable estimate.

10. The flexible price phase, involving an emissions trading scheme (ETS), is scheduled to run from 1 July 2015 onwards.

11. To help constituents in applying the Australian Accounting Standards, staff papers respectively dealing with accounting for carbon tax by emitters and by the Government were published on the AASB website in July 2011 and February 2013[3].

The 'liable entity' notion

12. The notion of a 'liable entity' is included in the CEA[4]. The Clean Energy Regulator (CER) describes the legislative requirements in regard to emission liability of entities falling under the Act as follows[5]:

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2 A person's emissions number for an eligible financial year (compliance year) is defined to be the sum of the person's provisional emissions numbers (PENs) for the eligible financial year. PENs represent the emissions from each facility, or embodied emissions from total supplies of natural gas, for which a person is responsible for an eligible financial year.

3 See http://www.aasb.gov.au/admin/file/content102/c3/AASB_Staff_Paper_Financial_Reporting_Implications_of_Carbon_Tax_for_Emitter_Entities.pdf and http://www.aasb.gov.au/admin/file/content102/c3/Government_Financial_Reporting_Carbon_Tax.pdf

4 Clarification has been obtained from Clean Energy Regulator in relation to provisions of the CEA regarding liable entities through staff correspondence.

5 Guide to Carbon Price Liability *under the Clean Energy Act 2011,* Clean Energy Regulator. See http://www.cleanenergyregulator.gov.au/Carbon-Pricing-Mechanism/Fact-sheets-FAQs-and-guidelines/Guidelines/Documents/Guide%20to%20Carbon%20Price%20Liability.pdf.

"you have a liability where the covered emissions from your facility exceed:

(a) A threshold of 25000- tonnes or more of Co2-e in the financial year if you are liable for the whole financial year, or
(b) A pro-rata threshold, if you are liable for part of the financial year, which is calculated by multiplying 25000 by the proportion of the year for which you are liable."

13. If an entity is a 'liable entity' (that is, if it expects to emit 25000 tonnes of CO2-e or more annually), then it should be registered under the NGER Act, report its emissions to CER and surrender enough eligible emission units (permits) to satisfy its liability by relevant designated dates in legislation, with any delay attracting further penalties.

14. The NGER Act (2007) requires registration and reporting of greenhouse gas emissions, energy use and energy production. Corporations that meet an NGER threshold must register and then report each year. As noted above, information collected under the NGER scheme provides the basis for assessing any liability under the CPM. Many liable entities under the CEA (2011) have already registered under NGER Act (2007) for their greenhouse gas emissions. Newly liable entities need to register under NGER Act by certain deadlines.

Liable Entities Public Information Database

15. Under the CEA, the CER must keep a database known as the Liable Entities Public Information Database (LEPID). Legal 'persons' will be included in the LEPID if the CER has reasonable grounds to believe the person is, or is likely to be, a liable entity for the eligible financial year (compliance year). Subsection 184(1) of the CEA states that

"if the Regulator has reasonable grounds to believe that a person is, or is likely to be, a liable entity for an eligible financial year, the Regulator must make an entry for the person on the Information Database". It must also *"give written notice of the entry to the person"* under subsection (2).

16. Thus, before entry on LEPID, the majority of entities are given the opportunity to comment on their proposed entry. The only time a person is automatically added to the LEPID is where they have confirmed their liability to the CER through some other means (eg as the result of an application for registration as a liable entity).

17. The LEPID, amongst other things, includes information about emissions numbers and estimate of total emissions for entities. LEPID is organised in terms of relevant compliance year, for example, LEPID for 2012–13 financial year.

18. The LEPID is a dynamic record that is updated frequently, as new information comes to hand. De-registering from LEPID is done through an application process. The database is updated on the basis of information received by CER, such as:

- liable entities' reported emissions and emissions unit information;
- changes to the list of liable entities due to individual circumstances, for example changes in corporate structure, divestment, and expected changes in activity/emissions, liability transfer or joint ventures; and
- number of surrendered units.

19. At any point in time, if an entity's name appears on the LEPID, there is reasonable ground to believe that the entity is a liable entity or is likely to be a liable entity for the compliance year

under the CEA. Because entries on the LEPID are made as a point in time assessment, the LEPID should not be considered conclusive, as there might be sub-threshold entities that are expected to be liable at the beginning of the year but, in the end, do not pass the threshold. Additionally, liable entities may transfer their liability using any of the liability transfer mechanisms provided for under the CEA[6].

20. Even when a new facility comes into operation in the coming compliance year, there are means at the controlling corporation's disposal to establish whether it is liable in relation to that facility. For example, based on projected activities for the facility, a person would be able to predict whether a new facility could be expected to be liable. The CER provides liable entities with tools to help them estimate what their emissions will be[7].

The effect of pro-rata threshold

21. As noted in paragraph 12 above, under the CEA, where a person has operational control over a facility for the entire year, they will only be a liable entity if the covered emissions from the facility for the year had a 25000 tonnes of CO_2-e or more. However, an entity has a liability when the covered emissions from its facility exceed a pro-rata threshold if it is liable for part of the financial (compliance) year. The threshold is calculated by multiplying 25000 by the proportion of the year for which the entity is liable.

22. Where a person has operational control over a facility for part of the year, the threshold to determine whether they are a liable entity is applied on a pro-rata basis. Examples of where a person might have operational control for part of a year include:

    (i) where there is a change in ownership of a facility; or
    (ii) where a facility permanently closes down part way through the year.

23. If a person has operational control over a facility for part of a year, the threshold should be calculated using the formula given under subsection 20(5) of CEA. Here the facility passes the threshold test if the total amount of covered emissions from the operation of the facility had a carbon dioxide equivalence of not less than *25,000 tonnes x Number of control days/number of days in the eligible financial year*. This means that the threshold test will be applied pro-rata to that proportion of the year that the person had operational control over the facility. Accordingly, if a person has operational control over a facility for one month (30 days) and the facility emits 2,055 tonnes of CO2-e or more of covered emissions during this period, the person with operational control will be liable for this amount of emissions as this exceeds the pro-rata threshold of 30x25000/365 or 2054.79 tonnes.

24. The pro-rata threshold requirement also applies to facilities that close permanently part way through the compliance year. However, if a person has operational control over a facility (such as a peaking plant) that operates intermittently throughout the compliance year, this is not considered permanent stoppage of production. In such a case, based on the definition of operational control[8], the threshold for liability is 25000 tonnes, as if the facility's intermittent emissions were made over the whole compliance year.

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6 Based on staff correspondence with CER.

7 For example, using the 'Threshold Estimator', available on the CER website at http://www.cleanenergyregulator.gov.au/National-Greenhouse-and-Energy-Reporting/Forms-and-calculators/Pages/default.aspx.

8 The definition of operational control can be found in section 11(1) of the NGER Act. Generally it involves having the authority to introduce and implement any or all of the following for the facility: (a) operating policies, (b) health and safety policies and (c) environmental policies.

Application of AASB pronouncements

25. Under paragraph 14 of AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* an entity should recognise a provision when:

    (a) it has a legal or constructive present obligation arising from a past (obligating) event;
    (b) an outflow of resources embodying economic benefits to settle that obligation is probable; and
    (c) a reliable estimate can be made of the amount of the obligation.

    The existence of a present obligation would mean the entity has no realistic alternative to settling that obligation.

26. AASB 137 (paragraph 19) clarifies that only those obligations arising from past events existing independently of an entity's future actions (that is, the future conduct of its business) can be recognised as provisions. When the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised. Applying this in the context of the fixed price phase of the CPM, it would mean an emitter entity does not have a present obligation to pay carbon tax in respect of its emissions before reaching the threshold of 25000 tonnes CO_2-e if it can avoid crossing that threshold by stopping the production. However, as discussed in paragraph 28 below, this may not necessarily be the case taking into account the legislative and regulatory requirements relating to application of pro-rata thresholds.

Australian Interpretation 21 position

27. Paragraphs 8, 11 and 12 of Australian Interpretation 21 are quoted below as they are seen as being particularly relevant to our analysis in the context of the fixed price phase of the CPM:

> "8 The obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation. For example, if the activity that triggers the payment of the levy is the generation of revenue in the current period and the calculation of that levy is based on the revenue that was generated in a previous period, the obligating event for that levy is the generation of revenue in the current period. The generation of revenue in the previous period is necessary, but not sufficient, to create a present obligation.
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> 11 The liability to pay a levy is recognised progressively if the obligating event occurs over a period of time (ie if the activity that triggers the payment of the levy, as identified by the legislation, occurs over a period of time). For example, if the obligating event is the generation of revenue over a period of time, the corresponding liability is recognised as the entity generates that revenue.
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> 12 If an obligation to pay a levy is triggered when a minimum threshold is reached, the accounting for the liability that arises from that obligation shall be consistent with the principles established in paragraphs 8–14 of this Interpretation (in particular, paragraphs 8 and 11). For example, if the obligating event is the reaching of a minimum activity threshold (such as a minimum amount of revenue or sales generated or outputs produced), the corresponding liability is recognised when that minimum activity threshold is reached."

28. Paragraph 12 of Australian Interpretation 21 echoes the clarification provided by paragraph 19 of AASB 137. However, arguably an entity with 'liable entity' status at the beginning of a compliance year cannot rely on the clarification in AASB 137 paragraph 19 and Australian Interpretation 21 paragraph 12 to avoid accruing a liability before crossing the 25000 tonnes annual threshold. This is because under the CEA, it will be liable for the portion of the year it operates before it permanently stops emission. It has a present obligation to pay carbon tax if it is classified as a 'liable entity' and emits even before reaching the annual threshold. This is because a pro-rata threshold comes into play.

29. Using Australian Interpretation 21 paragraphs 8 and 11 language, it might be said that the activity that gives rise to a liability to pay carbon tax is the emission of CO_2-e by a liable entity. The

obligating event occurs over a period of time and the liability to pay carbon tax would be recognised progressively. Using IAS 37, paragraph 19, language, with each unit of emission a liable entity becomes presently obligated to pay the carbon tax. This is similar to the cases noted in paragraph 19 where:

(a) unlawful environmental damage leads to a present obligation to pay penalties or incur clean-up costs; and

(b) damage already caused by oil installations or a nuclear power station leads to a present obligation to incur decommissioning costs.

In all these cases the obligating event leads to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity.

The case of new facilities

30. The question arises as to whether an emitter that is directly responsible for a new facility would be able to determine whether it is liable or is likely to be liable in respect of that facility. Prima facie, a direct emitter responsible for a new facility will not know it is a liable entity in relation to the facility until that facility has emitted covered emissions of 25,000 tonnes or more during the financial year. However, based on projected activities for the facility, a person would be able to predict whether a new facility could be expected to be liable. The CER provides liable entities with tools to help them estimate what their emissions will be, for example, the Threshold Estimator, available on the CER website[9].

31. The threshold estimator is a tool to assist users to self-assess if:

(a) a person is likely to be a liable entity under the CEA, and/or
(b) a controlling corporation is likely to have obligations to register and report under the NGER Act[10].

32. If an entity has been operating its facility for less than one year, it can either obtain the full year data from the previous facility operator or provide estimated annual data by multiplying the part year figures by 12 and dividing by the number of months it has been in operational control of the facility[11] for entry into the CER's Threshold Estimator.

33. If an entity expects to be a liable entity it should register under NGER Act and report its emissions to CER under that Act. Entities that assess themselves as being liable entities fall into two categories:

Category (a) entities that have an interim emission number, that is they emit or are likely to emit more than 35000 tonnes of CO_2-e in a compliance year.

Category (b) entities that emit or are likely to emit more than 25000 tonnes and less than 35000 tonnes of CO_2-e.

34. Entities in category (a) would need to register under the NGER Act by 1 May in the compliance year. However, to have an emission number, the entity should have emitted more than 35000 in the previous financial year. Interim emission number is usually calculated as 75% of emissions for the previous financial year or 75% of estimate emissions for the current compliance year. Having an interim emission number would mean the entity should surrender permits to cover the interim emission number by 15 June in the compliance year.

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9 See http://www.cleanenergyregulator.gov.au/National-Greenhouse-and-Energy-Reporting/Forms-and-calculators/Pages/default.aspx.

10 Under NGER Act, there are thresholds for both the 'facility' and the 'controlling corporation' that might have operational control of several facilities. Under CEA, the threshold only applies to the facility.

11 THRESHOLD ESTIMATOR, *Clean Energy Act 2011* and *National Greenhouse and Energy Reporting Act 2007,* USER GUIDE, p. 8.

35. As at the beginning of the current compliance year, Category (a) new entities might be able to assess whether they are likely to be a liable entity in respect of the compliance year. They have access to information about their previous year's emissions and can also use other means such as obtaining independent professional advice and/or undertaking independent investigations, and the threshold estimator. Arguably, these entities can begin accruing their emission liability as they emit and before reaching the 25000 tonnes threshold they are likely to be liable for the compliance year.

36. New entities falling under Category (b) would need to register by 31 August after the end of compliance year in which they become liable. Clearly, for such entities, if obtaining independent professional advice and/or undertaking independent investigations and use of assessment tools such as the threshold estimator does not lead to an assessment that they are likely to be liable for the compliance year, they would need to wait until they cross the threshold before recognising an emission liability. The obligating event for these entities would still be emitting as a liable entity but the liable entity element could not be ascertained before reaching the 25000 tonnes threshold.

The carbon tax staff paper position

37. The AASB Staff paper on accounting by emitter entities[12] notes that emission liabilities should be accounted for under AASB 137. Paragraph 34 of the paper states:

> "34. The emitter entity would be obligated to surrender permits for all its emissions in the compliance year if it emits beyond the emission threshold set out in the legislation. The entity would apply AASB 137 in recognising its emission liability. The entity would recognise a provision when the obligating event occurs and a reliable estimate of the amount of its obligation can be made. Some might argue that passing the threshold is the obligating event, but staff are of the view that the emission of carbon is the cause. In their view, when emission occurs, the probability of passing the threshold would be a factor in determining when to recognise the emission liability incurred. Thus an emission on day one of the scheme by a heavy emitter would be expected to result in the recognition of a liability on that day."

The staff paper notes that in "some cases, under AASB 137 it is conceivable that the event which accounting would see as giving rise to an obligation may take place earlier than the date or circumstances which leads to the related legal liability".

38. The staff paper position in relation to accrual of emission liability is arguably consistent with the legislative and regulatory requirements explained above. Many liable entities are heavy emitters (i.e. they exceed the 25000 tonnes threshold by a wide margin every year). Their status as heavy emitters most likely has been established under NGER Act requirements and prior to enactment of the CEA. Such entities would cross the threshold with very high probability and are obligated to pay carbon tax for every unit they emit, and the issue of crossing the threshold seems to be not relevant in establishing their present obligation.

39. Also arguably, a similar view could be applied to entities that previously emitted 35000 tonnes and would like to assess their liable entity status for the first time. These entities might also assess that it is highly probable that they will cross the threshold based on past experience, expert advice, investigations and using the threshold estimator. These entities would arguably need to recognise a liability as they emit and need not wait to pass the annual threshold in their first compliance year. For entities that control a new facility, there are means available to assess the probability of the facility's emissions crossing the threshold.

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12 AASB Staff paper – *Possible Financial Reporting Implications of the Fixed Price Phase of the Carbon Pricing Mechanism for Emitter Entities* see http://www.aasb.gov.au/admin/file/content102/c3/AASB_Staff_Paper_Financial_Reporting_Implications_of_Carbon_Tax_for_Emitter_Entities.pdf.

These include obtaining independent professional advice; undertaking independent investigations; and applying the clean energy regulator's threshold estimator tool. If all means fails, they may need to wait until they get closer to the threshold or until the threshold is crossed.

40. Therefore the applicability of Australian Interpretation 21, paragraph 12 seems to be limited to cases where the probability of crossing threshold is assessed at a level that warrants waiting until the threshold is reached. As noted in paragraph 36 above, the obligating event for these entities would still be emitting as a liable entity but the liable entity element could not be ascertained before reaching the 25000 tonnes threshold.

41. The position taken in the AASB staff paper in relation to recognising emission liability by emitters was developed having regard to AASB 137 recognition and measurement requirements. However, the notion of 'liable entity' under the CEA lends itself to the application of Australian Interpretation 21 requirements only in limited cases. Even in these cases the requirements of AASB 137 would arguably probably suffice.

Staff view

42. Staff are aware that there might be alternative views that would not fully correspond to the analysis in this paper. Staff are of the view that:
    (a) The 'liable entity' status of emitters can generally be established prior to reaching the 25000 tonnes threshold of CO_2 equivalent. Liable entities would be liable as they emit, similar to the damage done to the environment by oil installations or nuclear power plants, even before reaching the threshold.
    (b) Emitters have a number of means at their disposal to assess whether they would cross the 25000 tonnes threshold. These include:
        (i) obtaining independent professional advice;
        (ii) undertaking independent investigations; and
        (iii) apply the clean energy regulator's threshold estimator tool.
    (c) Entities that have an interim emission number generally are expected to emit 35000 tonnes of CO_2-e or more per compliance year. This is far beyond the 25000 tonnes liable entity threshold. Such entities would pay 75% of their previous year's emissions (or 75% of their estimated current year emissions) between 1 April and 15 June in the compliance year and would generally be able to assess whether they are liable entities before reaching the threshold.
    (d) In the case of some new facilities, the assessment of the probability of passing the threshold at the beginning of the compliance year may warrant waiting until a clearer picture of the extent of emissions emerges. In marginal cases, some might need to wait until the threshold is crossed before accruing an emission liability for the compliance year.
    (e) Liable entities would generally be able to apply AASB 137 in recognising their emission liabilities. The threshold requirement of Australian Interpretation 21 may only have application in limited cases, where a new emitter fails to ascertain its liable entity status using all available means.

Staff recommendation

43. If the Board agrees with staff analysis and views in this paper, staff recommend an amendment to Staff carbon tax paper to clarify the extent of applicability of Australian Interpretation 21 to the fixed price phase of CPM.

Questions to the Board:

Q1: Does the Board agree not to opine on whether the fixed price phase of the CPM is within the scope of Australian Interpretation 21 (see paragraph 5 above)?

Q2: Does the Board have any comments on staff view expressed in paragraph 42?

Q3: Does the Board have any comments on the recommendation in paragraph 43?

Q4: Does the Board think any further action should be taken on this issue?