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Submission on Proposed Benefit Sharing arrangements

Before addressing the Submission questions and to fully understand the context in which a benefit which proposed by the department is to be shared, we must address a major issue. This issue is why and how a department could determine that it is acting within its powers suggesting it has the right to give away "financial benefits", which are by contractual right, assets of the Commonwealth.

The APS operates under rules and a clear code of conduct which defines the behaviour required of public servants. These rules specify that public servants are to use resources in a proper manner and for a proper purpose, not facilitate a gain by others and not cause a detriment to the Commonwealth. At a macro level the suggestion that the department has the power to give away benefits, which are by contractual right assets of the Commonwealth and by my calculation worth around $3.5b is indeed a challenge. It sets a concerning precedent that agencies can, whenever they like, alter contracts to the benefit of others and the detriment of the Commonwealth. I doubt this is within the power of the department or the CER.

Furthermore, in regard to your consultation paper, important context is missing as to the factors which contributed to this current situation. Before addressing your individual questions, I wish to provide this context to ensure a more comprehensive positioning of the situation and my submission.

Consultation paper: Benefit sharing for the fixed delivery exit process

In 2021 accelerating overseas carbon prices, combined with increased commitments from businesses to limit their net carbon emissions created a situation where the supply of carbon from eligible projects was falling behind the demand. This caused the Australian carbon price to rise above $50 and market participants raised concerns that the prices they had been contracted to sell carbon to the Commonwealth ($12) was well below the then prevailing price ($50).

This was especially the case with early carbon abatement projects. When the ERF was started, participants considered the contracted price of $12 a ton to be "amazing". Given the prevailing price of $50 in 2021 and the contract sale price of $12 a number of these carbon market participants saw an opportunity to "raise concerns" and challenge the contractual commitment they had to the Commonwealth. They claimed that given the benefit that could be achieved by breaking their contract was so high and some of the largest market participants had moved into the hands of foreign owned US hedge funds; litigation was likely and could result in market instability.

In addition to the pressure from carbon market participants, the Department through the Minister, was under increasing pressure from business and Industry who either had made voluntary commitments to reduce net emission or were obligated to offset their emissions. They had not anticipated carbon prices would rise to $50 and exerted pressure on the Government to explore a way to reduce the carbon market price.

Faced with this situation the department/government had many options including selling into the market some of the ACCUs it was acquiring and converting the ERF to a carbon reserve bank thereby stabilizing the carbon market and operating a "dirty float" arrangement. Instead of undertaking any consultation the CER settled on an exit arrangement from fixed delivery contracts, based on the buyer's market damages provisions in the CACs that was to the advantage of some market participants and which caused a 40% fall in the carbon price almost overnight.

'Market participants that were advocating for a new arrangement said that resulting benefits should be shared'. It is unclear who these Market participants were and on what basis they became involved in the establishment of government policy that clearly benefits themselves is unknown.

On the basis that the proposed changes which had a potential economic impact of giving to market participants the financial benefit of $3.5B and naturally stripping the commonwealth of a financial benefit of $3.5b on 9 March 2022, the Clean Energy Regulator (the agency) announced that feedback will be sought on how to ensure a fair sharing of the financial benefits that result from exiting fixed-contract delivery obligations.

The agency is now consulting on a fair and reasonable way to share benefits from the exit arrangement.

Background

As announced on 4 March 2022, current holders of fixed delivery contracts will now be able to pay an exit fee to be released from fixed delivery obligations to the Commonwealth under a new initiative being offered by the agency. It should be noted that this represents a change in the contract terms. The contracts are quite clear and the exit fee arrangement (crafted on the default arrangement) was only available where a project could not produce the carbon anticipated and it was not designed to operate as an option where the project has carbon but, they don't want to pass the carbon to the Commonwealth.

The department has not provided any legal advice regarding the nature of the contract. I attach an opinion that clearly states that the department is making a choice not to enforce the contract but rather amend the contract and therefore not use the resources of the Commonwealth in a proper manner unless the Commonwealth was to substantially benefit from this change in contract.

The contracts are being changed by the Department in a minimal way. They are however, changes that the Commonwealth is making and which benefit market participants and as such it would be uncommercial if the Commonwealth did not share in the benefits of the change. The exit arrangement has been carefully designed to build on existing provisions in the Emissions Reduction Fund (ERF) contracts that allow contract holders to pay a penalty for defaulting on a given milestone delivery of Australian carbon credit units (ACCUs). This new exit arrangement was deliberately designed as a "minimal change" so rights under the ERF contract were not substantially altered. It is nonetheless important to note that this is a change in contract terms.

Proposed benefit sharing framework

What is benefit sharing?

'Benefits' refer to the additional revenue (net of the exit fee) obtained or expected to be obtained as a result of exiting fixed delivery contract milestones and selling ACCUs for higher prices than the contract may have provided.

It is important to understand that there would be no benefit to share if the ERF contract were not being changed by the Government. Based on prices applicable at the time the change was announced the Commonwealth controlled a potential financial benefit of $3.5b. Benefit sharing represents the allocation of this potential $3.5billion between the relevant parties.

Contractually the Government could keep all the $3.5b however the government is seeking comment on how it should share this benefit if realised.

What is the purpose of the benefit sharing framework?

The benefit sharing framework sets out the requirements and expectations to support benefit sharing on a fair and reasonable basis. The sharing needs to occur in a manner consistent with community expectations associated with contractual flexibility being offered by the Commonwealth and earlier undertakings by carbon market participants.

The Government perhaps has some sympathy for the farmers who celebrated when they sold carbon for $12 and now see the price is $50 and they want to share some of the benefits with them. The nature of the project may influence the sharing arrangement. It seems unlikely that the project sponsors have any additional work or cost to do arising from this change. Project sponsors are sophisticated carbon market participants who should fully understand the volatility of the carbon market.

What is the benefit sharing requirement?

The agency's expectation is that the benefit will be shared in a fair and reasonable way between parties that benefited from the CAC and will be reached through mutual agreement.

Benefit sharing arrangements must be agreed prior to applying for the exit arrangement.

Evidence of agreement between parties is required in the format of a declaration and signatures from each relevant party as part of the application process for the exit arrangements.

What is meant by fair and reasonable benefit sharing?

In the context of benefit sharing, fairness would be subject to a 'reasonable person' test (i.e., the reasonable person represents a judgment as to how a reasonable member of the community should behave in particular situations).

This expectation of fair and reasonable benefit sharing relates to the Commonwealth providing a new opportunity for the contract holder that is likely to lead to increased financial returns.

Having added context to your explanatory paper which is critical if you are truly seeking the best outcome, I set out my comments on your specific questions

1. Do you support a benefit sharing arrangement?

The idea that the Commonwealth should give up a benefit on a contract when carbon prices go up and then remain bound by the contract if prices fall makes no commercial sense. Therefore, there should be no benefit sharing as the Commonwealth should not change the ERF contract to create a benefit. I also question the departments power to give away the financial benefits of the Commonwealth without legislation.

To the extent that you proceed with the change in the ERF contract terms it is clear a benefit could arise. This benefit could be shared but as benefit currently belongs 100% to the Commonwealth you would expect that any sharing ensures the bulk of the benefit stays with the Commonwealth. As explained, given the size of the potential benefit, unsophisticated participants might argue that they were not aware of the potential benefit they were selling and therefore sharing some of the potential benefit could be reasonable. There is no reason to share any potential benefit with sophisticated project sponsors unless this change creates additional costs in the administration of the projects.

2. If yes, what features would a fair and reasonable benefit sharing framework have to help ensure financial gains created for the contract holder by the exit arrangement can flow to other relevant parties to the contract, depending on the situation?

I would suggest that at least 50% of the additional benefit above the exit fee are retained by the Commonwealth. The balance could be shared between the project host (site) and the project operator/sponsor. This balance should go to the project host unless the costs arising to the operator/sponsor are increased as a result of the contract change. I accept that where there is not a real host and it is a project such as a savannah burning project the balance could go to these groups etc.

3. Taking into consideration the many arrangements that may exist between carbon service providers and landholders or facility owners, how should the benefits flow?

The CER can cut the checks as all projects have to agree the split. The CER should chrnge an appropriate admin fee to cover the costs

4. What matters may affect reaching a fair and reasonable benefit sharing agreement?

None. The Government is currently entitled to 100% of the benefit. If no benefit sharing agreement can be reached between the parties, then the parties cannot benefit from the exit arrangement.

5. Should landholders that are CAC holders be able to access the exit arrangement without the agreement of CSP agents on benefit sharing if reasonable efforts to reach such an agreement are unsuccessful?

Yes. As is clear CSP Agents are sophisticated carbon market participants and the benefits they do secure out of the arrangement can only be classified as a windfall. Let's not forget they will receive about 20-30% of the price they contracted for in the first place (2-3$ a ton). Parties should act reasonably but in the event no agreement is reached, a min of 10% of the benefit should go to the CSP if no other agreement can be reached

In summary if sharing is to take place the Commonwealth must secure at a minimum 50% given they are the party agreeing to share anything. Following this the CSP perhaps 10% with the landholder etc getting 40%

Best regards

Oliver Yates

Attachment of legal advice

MARQUE

Our reference MB/12614
Phone
Email

14 March 2022

Oliver Yates
By email:

Dear Oliver

Emissions Reduction Fund Carbon Abatement Contracts

The Minister for Industry, Energy and Emissions Reduction, Angus Taylor, has announced that his government will "make changes" to the Emissions Reduction Fund by allowing sellers who are currently bound to fixed delivery Carbon Abatement Contracts (**CACs**), "to purchase an option to sell their Australian Carbon Credit Units (ACCUs) on the private market".

The announcement says further that "to activate the option to sell ACCUs on the private market, project proponents will be required to pay a fee equal to existing damages provisions in their contracts".

The CACs in question were entered into by the Clean Energy Regulator (**CER**) with entities in respect of proposed projects (**sellers**), for fixed prices, around $12 per ton of ACCUs. The open market price of ACCUs has escalated to around $52 per ton.

Each CAC imposes a set of express obligations on the seller: to sell and deliver the contracted ACCUs to the CER within a specified timeframe. The mechanism for delivery is that the ACCUs come into existence when the project is approved by the CER, and are credited to the seller's ANREU account. The seller is then obliged under the CAC to transfer the ACCUs to the CER's ANREU account.

The obligations to sell and transfer the ACCUs are essential terms of the CAC. If those obligations were not essential, then the contract would be a put option in the seller's favour. Clearly, on the CAC's terms, it is not a put option but an unqualified contract for purchase and sale. The seller must perform its obligations.

The CAC provides a mechanism for what happens in a circumstance where the seller fails to deliver the contracted ACCUs. This could occur in a situation where the project fails to produce the requisite ACCUs and the seller has no other ACCUs it can deliver. The mechanism provides that the seller must then pay an amount, the Buyer's Market Damages, to the CER.

The mechanism was not designed for a situation where the seller is able to perform its delivery obligation but simply chooses not to. If a seller does so, that would be an act of repudiation of the whole CAC, as it is a refusal to perform an essential obligation. The CER in that circumstance would be entitled to enforce the contract by suit for specific performance (forcing the seller to deliver the

ACCUs at the contract price), or to terminate and claim all of its losses arising from the seller's failure to perform. These losses would include the profits which the CER would have derived from the increased value of the ACCUs, but of which it has been deprived by the seller's act.

It has been argued in commentary that the CAC makes provision for Buyer's Market Damages to be paid by sellers "for other purposes", with the result that the delivery obligation is not enforceable against sellers under any circumstances. That is incorrect and comes from a misreading of the CAC's terms.

The Minister's announcement constitutes a choice by the government to cause its agency, the CER, to not enforce its contractual rights under the CACs and consequently to forgo its entitlement to the profits that it (and the Australian public) would have obtained from the increased value in the ACCUs which it contracted to buy. Instead, those increased profits will go to the private entities who are bound to deliver the ACCUs under their contracts but are now being let out of their obligations.

Yours sincerely

Michael Bradley
Managing Partner