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National Carbon Offset Standard: Key Issues and Contentions

On 15 December 2008 the Commonwealth Government released a White Paper outlining the final design of the Carbon Pollution Reduction Scheme (CPRS) and the medium-term target range for reducing emissions. Following this, the Government released a Discussion Paper and draft National Carbon Offset Standard (the Standard) intended to apply to voluntary abatement activity that occurs beyond that imposed by the Scheme.

The purpose of this paper is to clarify key elements of the proposed Standard, which will have significant implications for voluntary abatement action and current approaches to carbon offsetting and carbon neutrality. It is intended that this paper will assist interested parties who wish to make a submission on some of the key issues raised in the Discussion Paper.

BACKGROUND

The CPRS is the key component of the Government's approach to reducing greenhouse gas emissions.

As described in the White Paper, the CPRS employs a cap and trade mechanism to impose a limit or 'cap' on the collective emissions of all sectors covered by the emissions reduction scheme. Entities responsible for emissions sources covered by the Scheme will be obliged to acquire and surrender a permit (an Australian Emissions Unit) for each tonne of CO₂ equivalent that they have emitted during the compliance period.¹ Entities compete to purchase the number of permits that they require, either at auction or on a secondary trading market.² Entities are likely to be willing to pay for permits if their internal costs of abatement are higher than the price of permits, or to directly reduce their emissions if their internal costs of abatement are lower than the price of permits.

The CPRS will apply to direct (scope 1) emitters that release 25,000 tonnes of CO₂ equivalent or more per year. The Scheme will cover the emission of all six Kyoto Protocol greenhouse gases³ from the stationary energy, transport, fugitive, industrial processes, waste and forestry sectors. Because of difficulties in calculating emissions, the CPRS will not initially cover emissions from agriculture. The Government has indicated however that the inclusion of agricultural emissions in the Scheme is desirable and a final decision on inclusion or exclusion will be made in 2013. The Scheme will also exclude emissions from deforestation (i.e. the conversion of forested land to alternative uses). However, forests that meet specified criteria will be able to opt voluntarily into the CPRS. In that case, the sequestration of carbon dioxide by those forests will generate carbon pollution permits (in addition to the cap) and subsequent clearing will be deemed to produce greenhouse gas emissions that will need to be covered by the surrender of permits.

¹ However note that in addition to AEU's the following units will be accepted for compliance with the Scheme: international units generated from CDM abatement projects (Certified Emissions Reductions), JI projects (Emissions Reduction Units), and on the basis of land use, land use change and forestry activities (Removal Units); additional permits issued under the price cap mechanism, additional domestic permits issued as a result of forestry activities, and, if allowed, Scheme offsets. The effect of this is that entities will be able to generate additional emissions above the Scheme cap.

² The majority of permits within the Scheme will be auctioned, however certain categories of firms will receive an administrative allocation of permits, as a transitional assistance measure. The White paper indicates that over the longer term there will progressively be a move towards 100 percent auctioning.

³ Carbon dioxide, methane, nitrous oxide, sulphur hexafluoride and specified hydrofluorocarbons and perfluorocarbons.

As a result of its broad coverage the Scheme will cover around 75 per cent of Australia's emissions from commencement.⁴

The Government does not propose to introduce a regulated carbon offset regime for uncovered sectors during the initial period of the Scheme's operation, however, will consider the scope for domestic offsets in 2013, following final decisions on coverage on agricultural emissions. The White Paper notes that the creation of a regulated carbon offset regime for uncovered sectors would not increase national abatement because the creation of offsets would allow sectors covered by the CPRS to generate additional emissions (above the cap) to the extent that those emissions have been 'offset' by abatement in uncovered sectors.

The Government recognises, however, that some individuals and entities may choose to reduce their emissions beyond mandatory obligations under the Scheme by voluntarily offsetting carbon emissions. Entities may be motivated to undertake voluntary activity for a number of reasons including commitments to social corporate responsibility or the desire to market products and services as carbon neutral. A primary concern regarding voluntary carbon offsets, though, is their integrity. The Commonwealth Government has therefore developed the National Carbon Offset Standard which will provide assurance as to the integrity of offsets.

THE NATIONAL CARBON OFFSET STANDARD

The purpose of the Standard is to establish a national benchmark as to what constitutes a legitimate carbon offset. The Standard intends to provide a means of ensuring the integrity of voluntary offsets that are sold in Australia. The proposed Standard provides guidance on what constitutes a genuine, additional voluntary offset credit, set requirements for the verification and retirement of such credits, and provides principles for calculating the emissions of an organisation, product or service which could be offset. The Discussion paper suggests that the Standard will be voluntary.

In order for domestic abatement projects to be considered valid, the proposed Standard requires that projects be:

- **Additional** - abatement generated must be beyond what would be undertaken as part of business-as-usual investment or beyond what is required by regulation.
- **Permanent** - emission reductions must be permanent.
- **Measureable** - methodologies used to quantify the amount of abatement generated must be robust.
- **Transparent** - consumers and other interested stakeholders must be able to examine information on projects by accessing a publicly available website.
- **Independently verified** - eligibility of the project and abatement subsequently generated must be validated by a non-interested third party. Existence of a conflict of interest should also be determined.
- **Registered** - units generated must be registered and tracked in a publicly transparent registry.⁵

The Government is seeking views as to whether these are appropriate principles to include in the Standard. The principles are based on the Clean Development Mechanism under the Kyoto Protocol which is widely regarded as the benchmark for credible offsets. The Standard itself is therefore not likely to be as controversial as some of the other issues surrounding voluntary abatement action under the CPRS. Some of these issues are discussed below.

⁴ Carbon Pollution Reduction Scheme: Australia's Low Pollution Future. White Paper. Volume 1, December 2008, p6-1.

⁵ Draft National Carbon Offset Standard, p15.

HOW WILL THE CPRS AFFECT VOLUNTARY ACTION TO REDUCE EMISSIONS?

The introduction of the CPRS has implications for three key voluntary abatement issues: the range of domestic offsets that can secure genuine environmental outcomes under the Standard; the concept of carbon neutrality; and direct individual abatement action.

Domestic carbon offsets

The challenge that the CPRS creates for the voluntary carbon market is that the scope for voluntary offsets is limited to emissions reductions in sectors that are not covered by the Scheme. In particular, the broad coverage of the Scheme inherently leaves few emissions sources to be developed as voluntary offset projects. Further, the White Paper indicates that where practical the Government will apply alternative mitigation measures to sources that cannot be covered or are likely to remain outside the Scheme for an extended period of time. Offsets can only be created for abatement that is additional to such measures⁶. Thus the scope for domestic offset activities from uncovered sectors is likely to be very limited.

Nevertheless some emissions sources are likely to remain outside of the Scheme. For example, emissions from deforestation will not be included and the Government has noted in the White Paper that emissions from savannah burning are unlikely to be covered. Also, as an alternative to opting in to the Scheme, forest landowners can forgo coverage and instead create and sell offsets in the voluntary market.

Interestingly, the Discussion Paper notes that such offsets may not be truly additional under the Standard because net emissions from uncovered sectors are taken into account in determining the Scheme's cap and therefore count towards meeting Australia's internationally agreed targets. Applying this analysis, only abatement in emissions from sectors not covered by the CPRS and that are not included in the calculation of Australia's international commitments are considered truly additional. Emissions reductions which occur within a sector counted toward Australia's Kyoto target will simply free up Assigned Amount Units (AAUs) that can be used to cover an increase in another entity's emissions while Australia still meets its international target. As a consequence, offset buyers will likely turn to purchasing offsets from international carbon reduction projects in non-Kyoto capped countries.

Domestic offsets generated in uncovered sectors and counted towards Australia's Kyoto target could, however, be additional to Kyoto obligations if the Government adopted an approach of cancelling AAUs equivalent to the credits.

The Government is seeking stakeholder views on the question of whether domestic offsets from uncovered sources should contribute to Australia's Kyoto obligations or whether AAUs equivalent to the credits should be cancelled to provide additionality beyond Kyoto obligations.

Carbon neutrality

The Discussion paper suggests that the introduction of the CPRS will alter the concept of carbon neutrality.

The term carbon neutral commonly refers to a position where the net CO₂ equivalent emissions associated with an individual's or entity's activities, products or services are zero.⁷

Carbon neutrality has been a key driver of demand for offsets. In the absence of the CPRS, if an entity undertakes action to offset all its emissions the result would be no net emissions in the atmosphere.

⁶ Offsets are only considered to be legitimate if the abatement generated is beyond what would have been undertaken as part of business-as-usual investment or beyond what is required by regulation. That is, they generate emissions reductions that would not have otherwise occurred.

⁷ Draft National Carbon Offset Standard, p5.

With the introduction of a binding cap on aggregate emissions under the Scheme, the link between individual entity action and aggregate emissions is broken.⁸ As the Discussion paper explains, any increase in emissions from sources that are covered by the Scheme will increase the demand for permits. Increased demand will increase the permit price, driving emissions reductions by other liable entities where the cost of reducing emissions is cheaper than purchasing permits. As such, any increase in emissions is offset by a reduction in emissions elsewhere under the cap. As a result the net change in aggregate emissions is zero. The Discussion paper therefore suggests that if liable entities acquire and surrender permits to cover all of their emissions from sectors covered by the CPRS, the entity could be considered 'carbon neutral' in the sense that its emissions have had no net impact on aggregate emissions as defined by the cap.⁹ The Government is therefore proposing a new definition of carbon neutral that does not accord with current the understanding of that term.

Given that the operation of the Scheme will alter the concept of carbon neutrality, the Discussion Paper proposes that the term 'additional voluntary action' may be appropriate to recognise voluntary activity in the context of the CPRS. Under the Scheme if liable entities wish to counteract or offset all, or a portion of their carbon emissions they will need to meet this cost in addition to the cost of purchasing permits. They can do so through the purchase and voluntary surrender of AEU's, the purchase and voluntary surrender of eligible international units, or the purchase of 'carbon credits' or 'offsets' which have been generated by emissions reduction projects in uncovered sectors. Note that an entity that offsets all of its emissions through 'additional voluntary action' would meet the currently accepted definition of carbon neutral.

Given the introduction of the Scheme alters current understandings of carbon neutrality the Government is seeking stakeholder views on whether the term 'carbon neutral' is still meaningful in the context of a cap and trade scheme, whether the concept of 'additional voluntary action' is more appropriate to recognise voluntary activity beyond compliance with the Scheme, and whether it is now appropriate for an entity with all emissions covered by the Scheme to be considered carbon neutral if it does nothing more than comply with the Scheme.¹⁰

Direct individual action

In the absence of the Scheme, individuals and entities can undertake voluntary abatement directly by, for example, improving energy efficiency or buying accredited renewable energy (i.e. green power).

With the introduction of a binding cap on emissions under the CPRS, if voluntary abatement actions occur within sectors covered by the Scheme, they will not result in an additional environmental benefit beyond the cap. As discussed above, any decrease in emissions from sources that are covered by the Scheme will drive an increase in emissions elsewhere under the cap, with no net reduction in aggregate emissions. For example, if individuals and uncovered entities reduce their energy use by installing solar hot water systems and implementing other energy efficiency measures, the reduced demand for electricity means reduced emissions from the electricity sector and therefore reduced demand for carbon pollution permits (and reduced permit price), which consequently frees up permits for use by other sectors under the Scheme. Therefore, in covered sectors, individual action could affect the permit price and who pays, but not the aggregate quantity of emissions, which is fixed at the cap. Consequently, the Scheme as designed displaces direct voluntary efforts to reduce aggregate emissions beyond the cap. This is considered to be an intrinsic part of a broad based scheme designed to reduce emissions at least cost to the entire community. The Government also notes that voluntary emissions cuts in Australia to date have not had a real impact on rising emissions and the introduction of mandatory emissions reduction obligations for Australia's largest emitters has the potential to drive significant reductions in emissions.¹¹

⁸ National Carbon Offset Standard Discussion Paper, p5, 7.

⁹ National Carbon Offset Standard Discussion Paper, p8.

¹⁰ National Carbon Offset Standard Discussion Paper, p10.

¹¹ Australia's emissions have steadily risen each year since 1995 despite voluntary emissions reduction activities. See Carbon Pollution Reduction Scheme: Australia's Low Pollution Future. White Paper, Volume 1, December 2008, pp4-5, 4-6.

This result has attracted considerable criticism, as it reduces the incentive for individuals to adopt energy efficiency measures because their actions do not translate into overall emissions reductions.¹² A number of commentators have noted that voluntary action could contribute to emissions reductions over and above what will occur under the CPRS and the Government should consider ways to measure and recognise voluntary emissions cuts under the Scheme.

If the Government does not allow voluntary action to be recognised under the CPRS it is especially critical for the cap set to be meaningful and assist Australia in achieving real reductions in greenhouse gas emissions. This is the most crucial aspect of the Scheme.

It is also important to note that although individual action under the CPRS does not directly lead to emissions reductions in the short term, voluntary abatement action does however contribute to Australia's climate change response. Energy efficiency measures and investment in renewable energy is, for example, important to support the development and growth of zero emissions and abatement industries so that further and deeper cuts to emissions can be set in the future.

WHAT CAN INDIVIDUALS AND ENTITIES DO TO REDUCE EMISSIONS BEYOND THE CAP?

Voluntary surrender of permits

While the CPRS limits the feasibility of voluntary domestic offsets and breaks the link between direct individual action and aggregate emissions, there are some arrangements under the Scheme to support individuals and entities to undertake voluntary action to reduce emissions beyond the Scheme cap.

The Government has indicated that carbon pollution permits can be held and traded by any legal or natural person. It therefore makes possible the purchase and voluntary surrender of carbon pollution permits by individuals and entities regardless of whether they have obligations under the Scheme. The voluntary surrender of permits effectively reduces the number of permits available to firms that have emissions liabilities under the CPRS cap, and so tightens the cap itself. This will put pressure on the permit price and scheme compliance. If sustained over the long term, an increased permit price will make covered sector entities' investment in low emissions technologies and abatement an economically attractive alternative to buying permits. The White Paper states that the Government will not impose any quantitative restriction on voluntary surrender at this time.

The Standard also proposes to recognise the following types of units as eligible carbon offsets where they are voluntarily surrendered: Certified emissions reductions (CERs) generated from CDM abatement projects (other than long term or temporary CERs), Emissions Reductions Units (ERUs), from JI projects, and Removal Units (RMUs), which are issued on the basis of land use, land use change and forestry activities. Therefore, individuals and uncovered entities can also purchase and voluntarily surrender any type of eligible international unit in the national registry.¹³

To ensure that the voluntary surrender of a carbon pollution permit will increase Australia's contribution to the global mitigation effort above and beyond the commitment agreed to in international negotiations, the Government will cancel an international unit for each AEU voluntarily surrendered under the CPRS. To ensure that each eligible international unit that is voluntarily surrendered also represents further reduction, the Government will cancel that unit so that it cannot be used by the Australian Government to meet its international obligations under the Kyoto Protocol.

¹² Total Environment Centre, 'Crunch time for offsets', September 2008; The Australia Institute, 'Fixing the Floor in the ETS: The role of energy efficiency in reducing Australia's emissions', November 2008; The Sydney Morning Herald, 'Eco homes to give dirty industries a free ride' 26 January 2009; The Age, 'Solar not being taken seriously, says enthusiast', 31 January 2009.

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Therefore the CPRS design enables individuals and entities, who in the past have offset their activities through the voluntary market, to contribute to emissions reductions beyond the cap through the voluntary purchase and surrender of compliance market permits and eligible international units.

Other potential individual action

In addition to the voluntary surrender of carbon pollution permits and eligible international units, there are potential opportunities for individuals and entities to reduce their emissions in sectors not covered by the Scheme. For example, the sequestration of emissions through voluntary planting of trees (i.e. not for the purposes of generating offsets) would result in a net reduction of Australia's greenhouse emissions beyond the Kyoto and CPRS caps. This concept is only just being explored by non-government organisations and carbon offset providers and potential opportunities are likely to become clearer over the next few months.

ABOUT THE ENVIRONMENT DEFENDERS OFFICE (VICTORIA) LTD

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