Contracting for a Carbon price: Are you subsidising your competitors?

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The Federal Parliament is one (very significant) step closer to implementing the Carbon Price Mechanism (**CPM**) and their Clean Energy Future Plan of the Multi-Party Climate Committee.

Companies should consider their potential liabilities, both direct and indirect as part of a supply chain, and revisit their existing contracts and general contractual positions. Companies which have not been considering these issues may now find they are exposed to potentially significant commercial risks, particularly if their competitors have adopted a more proactive contracting approach by securing favourable carbon cost pass-through clauses or fixed prices.

How are carbon costs to be regulated?

The CPM, like its forebear, the Carbon Pollution Reduction Scheme (**CPRS**), targets upstream generators of energy and producers of direct emissions. Critically, the new legislative package does not regulate how commercial parties are to share risks and costs through the supply chain via their various contracts.

This should come as no surprise. At the Senate Economics Committee inquiry into the CPRS in 2009, a number of stakeholders such as Santos Limited and the Australian Pipeline Industry Association (APIA) urged the Government to step in and regulate carbon cost pass through in the following circumstances:

1. where contracts were entered into before the CPRS was announced;

2. where carbon-cost pass through had not been dealt with in the contract; and

3. where the contract was non-reviewable for carbon costs.

These concerns and requests were flatly rejected by the Committee who considered that it was not the Government's role to 'make good' contracts which were 'technically defective' because commercial parties failed to draft clauses to deal with the introduction of a carbon price (which they should have anticipated even if the contract was signed many years ago). [1]

The new Clean Energy Regulator will have the primary role of administering the CPM and enforcing the *Clean Energy Bill 2011*. In other words, its focus will be on preventing 'carbon fraud' rather than looking at pricing arrangements agreed between private contracting parties.

The enhancement of the ACCC's powers and budget to monitor and police alleged 'price-gouging' in the initial years of the scheme means that companies should be wary of making statements about the impact of the carbon price on their standard rates for goods or services or at least ensure that their representations are not misleading. However, there is no legislative prohibition against 'price-gouging' under contracts unless it contravenes existing provisions in the Australian Consumer Law. Please see our **article below** for more information.

Who needs to consider carbon pass through costs?

For upstream suppliers and direct emitters, the ability to pass on cost increases is a commercial imperative. Simply relying on standard 'change in law' clauses in existing contracts is unlikely to produce satisfactory results in many situations, particularly where such clauses may be undermined by other terms in the contract and where they rely upon imprecise notions such as the change being 'unforeseeable' or that the new law must 'apply' directly to a contracting party or project.

On the other hand, **all** businesses (particularly large energy consumers, or those that use products with high carbon-intensity) need to ensure that they are not left shouldering the full burden of costs passed through from upstream producers and suppliers. Distributers, mid-tier suppliers and operation and maintenance businesses may be caught in the middle and need to ensure that they negotiate the best possible terms on both the input and output sides of their business.

The exclusion of certain transport fuels has substantially reduced the number of entities with direct permit obligations under the future CPM (because many entities covered by the CPRS will no longer exceed the facility emissions threshold of 25 kilotonne of Scope 1 CO_2-e which also applies under the CPM).

Nevertheless, the CPM will affect almost all sectors of the economy and the reduction in fuel tax credits under the *Fuel Tax Legislation Amendment (Clean Energy) Bill 2011* (Cth) for certain entities will ensure that an 'effective carbon price' is applied to most of those fuel types which have been excluded from the CPM (ie off-road transport fuels from commencement on 1 July 2012 and heavy on-road liquid fuels from 2014). See **article below** for more information in respect of the changes to the Fuel Tax Credit scheme.

All companies should currently be considering their exposure and reviewing their carbon pass- through and change in law clauses in existing and future contracts. Given the legislation has now passed the lower house, change in law clauses entered into from today are unlikely to be sufficient in the absence of a specific contractual mechanism to allow for pass-through of increased costs.

Key considerations when contracting

Gadens Lawyers has witnessed diverse approaches in the marketplace to carbon cost pass-through clauses and these are often imprecise and sometimes oppressive. Below are some of the questions contracting parties should consider:

- It should be expected that providers of energy or carbon-intensive goods and services who are locked into contracts preventing or limiting their ability to pass on extra costs under a carbon price, will seek to claw back these costs elsewhere (ie under other contracts with other customers). Does your contract prevent (or minimise) such claw backs or are you simply subsidising the contractor for its other poor contracting decisions whilst your competitors remain insulated from the carbon price?

- Is a change in law regime sufficient to cover an emissions trading scheme and, more particularly, the CPM which has been passed by the House of Representatives?

- Does the clause refer to changes in law directly affecting the parties or the specific project/goods which are the subject of the contract or is the clause broad enough to cover any new legislation affecting the input costs of the contracting parties?

- Is there a requirement that the law is not foreseeable at the time of contracting?
- Are the costs passed-through directly incurred or indirectly incurred?
- Are the costs passed-through specific to costs affecting the project or goods which are the subject of the contract, or do they permit generic costs incurred by a company across all its operations and averaged out?
- Are the costs passed-through 'net costs' which apply a reduction or otherwise provide a set-off from costs passed-through to account for any government subsidies or compensation (such as free permits) received by the party seeking to pass through carbon costs?
- Is there an obligation to mitigate costs, demonstrate emissions reductions or purchase of permits at the cheapest possible price in the 'flexible price period' of the CPM?
- Is there transparency in the cost pass-through regime?
- If a formula is included to calculate the amount of pass through permitted, does this formula account for the different emissions intensities of power generation between states (see NGER Act) and is this to your advantage or disadvantage depending on the main geographical areas of operations?
- Is there a right to terminate or an express right to renegotiate in the event that the costs passed through make the contract rates uncompetitive in the broader marketplace?
- What is the dispute resolution mechanism for disputes over costs pass through? Should there be a price review procedure in place for the parties, or an independent body or experts to deal with and determine price rises?
- Are the costs passed through only related to permit obligations under a CPM or do they extend to other incidental compliance costs? For example, does the change in law or carbon cost pass through clause entitle costs to be passed through where these costs are incurred as a result of changes to tax credits or changes in excise as an 'equivalent carbon price', but without any corresponding permit obligations (eg this applies to some transport fuels as part of the CPM)?
- Do the change in law or carbon cost pass-through clauses dove-tail with other pricing and limitation of liability clauses in the contract?
- Are there rise and fall clauses or other clauses which could allow for carbon cost pass-through by stealth?
- Do the cost pass through provisions reflect the assignment of obligations under the NGER Act as well as allow for flexibility in anticipation of potential permit obligations under a CPM?
- How does the contract deal with carbon cost pass-through in joint venture arrangements (both incorporated and unincorporated) and is it consistent with reporting obligations under the NGER Act and is it sufficiently flexible in anticipation of potential permit obligations under a CPM?
- Does the contract allow for pass-through (and appropriately apportion costs) in situations where a 'liability transfer certificate' has been issued (ie where an entity volunteers to take on permit

obligations) transferring liability from an operator to an owner, from a controlling corporation to a subsidiary or from an operator to other participants of an unincorporated joint venture?[2]

Wherever possible, drafters should ensure clarity of language, transparency of pass-through calculations/regimes and integration with existing clauses. Clauses should be as simple or sophisticated as the case requires, however, companies and their advisers should ensure that all carbon pass through risks are properly identified and managed.

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