

4 Penalty and make-good provisions

This Chapter examines the role of penalty and make-good provisions in enforcing compliance with the NETS cap. Penalties can be used to set a price cap on emission permits and the overall cost of the scheme.

4.1 Compliance with the scheme cap

Compliance with the scheme cap can be encouraged by applying a penalty in the event that a scheme participant has insufficient permits to cover its emissions during a compliance period. The penalty can potentially serve two important purposes:

- encouraging compliance, and thus promoting the environmental integrity of the scheme
- capping the cost of compliance and providing certainty to investors about the maximum costs of the scheme.

An additional incentive to meet the cap and maintain the environmental integrity of the scheme could be provided through the use of a ‘make-good’ provision, which requires a scheme participant that exceeds its emissions cap to pay a penalty, as well as to surrender an equivalent number of permits.

This Chapter sets out proposals in relation to the penalty level and discusses whether a make-good provision should be included in the scheme design.

4.2 Penalty

4.2.1 Level of penalty

To induce liable parties to comply with the scheme, the level of the penalty must be set at least as high as the marginal cost of abatement (which will determine permit prices), taking into account any transaction costs associated with compliance. If the penalty were lower than this, then it would be cheaper for a liable party to pay the penalty than to comply. This would limit the effectiveness of the scheme in reducing emissions.

Setting the penalty at an appropriate level to encourage compliance is likely to be more art than science. This is because the future costs of achieving an emissions cap can be estimated, but never known in advance. Modelled costs and actual costs could vary for a large number of reasons, including changes in fuel costs, technology costs, energy demand, or unrelated incentives to invest in different types of technology.

Setting a high penalty level is likely to encourage compliance, since compliance would be cheaper than paying the penalty. However, it raises a practical credibility problem: if a scheme participant were threatened with insolvency if it were required to pay a very high penalty, would governments actually enforce that penalty?

Conversely, low penalties have their own risks. First, they are less likely to induce compliance than high penalties unless they are coupled with a criminal penalty or unless they are in addition to the need to make up the shortfall. This is because the actual cost of compliance could rise beyond the level of the penalty, and it would be cheaper for scheme participants to pay the penalty than to comply. This could give greater certainty to investors in relation to future compliance costs, as they would be capped to a certain amount. However, this raises its own credibility issue: if the penalty were consistently found to be too low (that is, it induced too little abatement), then governments could raise the penalty. Should this occur, the investment certainty created by a low, pre-set penalty would be more apparent than real.

The level of the penalty could also be tiered. For example, lower penalties could be set for firms that breach their obligations by a small margin, with higher penalties applying to firms with more serious breaches. In addition, quite different penalties could be appropriate for offences other than failing to surrender permits, such as providing false and misleading information to the Scheme Regulator (see Chapter 8 for further detail on institutional arrangements).

In Australia, the penalties for the MRET, VRET, the NSW and ACT GGAS and the Queensland 13% Gas Scheme are similar to compliance costs (either estimated or real). This appears to be because a large emphasis has been placed on the role of the penalty in capping ultimate compliance costs. To date, the level of compliance under those schemes has been very high.

In the United States, to create powerful incentives for compliance, penalties for the SO₂ Allowance Trading and over-the-counter (OTC) Regional NO_x Trading Programs have been notionally set at three times the cost of an allowance. Compliance levels of 99.9% have been achieved to date under both programs.

In the EU ETS, the Phase I (2005–07) penalty is €40 per tonne of CO₂, rising to €100 per tonne of CO₂ for Phase II (2008–12). That penalty appears to reflect a greater emphasis on ensuring compliance, rather than on capping compliance costs.

The tax treatment of penalties compared with the purchase of permits must be also taken into account. Penalties are not a tax-deductible business expense, whereas the cost of purchasing a permit would be considered a legitimate business expense. Therefore, a firm would be prepared to spend more on a permit than the nominal penalty level—assuming that the firm was in a tax-paying position.

Finally, if a scheme implemented in Australia were ever bilaterally linked with an international scheme, then penalties in the Australian scheme ideally should be related to the level of the penalty in the international scheme. This is because penalties set a cap on the prices of permits—if the cap on prices is different across countries, then the country with the lower penalty might tend to export permits and risk breaching its emissions cap. It is important to note, however, that this would occur only if the price of permits was above the domestic penalty level but below the international penalty level.

4.2.2 Form of penalty

The penalty may take a civil or criminal form, depending upon the severity of the caps imposed. For example, if non-compliance were made a criminal offence it could result in a criminal record and jail sentences. In terms of perceptions, a civil penalty is likely to carry much less of a stigma than a criminal penalty. Therefore, if a criminal penalty were set at, say, \$20/t CO₂-e, a firm might be expected to pay significantly more than \$20 for a permit to avoid a criminal conviction. Put simply, a criminal sanction is likely to have a greater deterrent effect than its civil penalty counterpart.

In Australia, the tradable certificate schemes currently in operation all adopt civil penalties for the offence of failing to surrender sufficient certificates. In some instances, criminal sanctions are also imposed for other offences. For example, the NSW and ACT GGAS legislation makes it a criminal offence to obstruct the GGAS Scheme Administrator and provides for a maximum penalty, including a 6-month prison term. Giving false or misleading information carries a maximum penalty of 12 months' imprisonment under MRET scheme legislation, and improperly creating certificates carries a maximum penalty of 6 months' imprisonment under the Queensland 13% Gas Scheme legislation.

The EU ETS imposes a civil penalty for non-compliance and requires publication of the names of those scheme participants that are not in compliance. Additional administrative penalties also apply, such as for the operation of an installation without a permit or failure to comply with an enforcement notice, failure to comply with a monitoring and reporting condition, and fraudulent reporting. In Sweden and Ireland, severe infringements attract fines and imprisonment up to 1 and 10 years, respectively.⁴¹

In the United States, the SO₂ Allowance Trading program applies a civil penalty of US\$2,000 (1990 dollars), adjusted annually for inflation, for each ton of excess emissions above allowances held. The penalty for non-compliance in the OTC Regional NO_x Trading Program is an allowance penalty at a ratio of three-to-one. In other words, for each ton of excess emissions, a source must submit three allowances to the regulating

⁴¹ European Environmental Agency 2006, *Application of the Emissions Trading Directive* by EU Member States, EEA Technical Report No. 2/2006.

authority. Non-compliance with monitoring, record-keeping and reporting requirements under the SO₂ Allowance Trading and OTC Regional NO_x Trading Programs can also attract criminal penalties.

4.2.3 Stakeholder views

A number of submissions in response to the Background Paper supported the use of the penalty as a price ceiling in order to provide economic certainty.⁴² For example, the Energy Supply Association of Australia noted that:

... economic costs cannot be allowed to escalate out of control when the environmental costs of not meeting the target are unknown. (submission 55, p.9)

The Business Council for Sustainable Energy also argued:

... that a penalty price providing a price cap is of important reassurance to a community that is completely unfamiliar with the likely impacts of an emissions trading scheme and can help to address any potential misinterpretations that might emerge in the media and other sources. (submission 24, p.79)

The Australian Wind Energy Association (submission 40, p. 8) commented that the penalty should be set a level that does not significantly limit economic growth, reflects the technical and commercial potential of abatement, and requires Australia to improve its emissions intensity per unit of Gross Domestic Product.

By contrast, environmental groups⁴³ generally argued that high penalties should be used to ensure compliance, rather than to cap compliance costs. For example, Environmental Defender's Office NSW (submission 49, p. 20) argued that capping costs would benefit participants but could undermine the environmental integrity of the scheme.

4.2.4 Assessment

As noted above, determining the level of the penalty is not a clear-cut exercise. Setting the penalty just above the estimated costs of compliance would value capping the costs of the scheme more highly than absolute compliance with the cap, and *vice versa* for penalties that are multiples of that estimated cost.

⁴² The Energy Users' Association of Australia, Energy Supply Association of Australia, Origin, Queensland Resources Council, Loy Yang Marketing Management Company, Australian Industry Greenhouse Network and Sustainable Solutions.

⁴³ Australian Conservation Foundation, World Wide Fund for Nature, Environmental Defender's Office NSW and Total Environment Centre.

It is proposed that the penalty be set at a level that caps the cost of the scheme at an acceptable level but also encourages compliance. This approach best meets the scheme objectives outlined in Chapter 1 and is consistent with the 10 key design propositions.⁴⁴ In particular, it provides investor certainty by allowing investors to make decisions in the knowledge of an upper limit on future compliance costs. In this way, the potential impacts on the economy are also minimised because it allows for the overall scheme costs to be capped if economic and emissions growth are higher than expected.

At the same time, the level of the penalty would be set to avoid a shortfall in abatement and thereby maintain the environmental integrity of the scheme. Clearly, robust estimates of future compliance costs are required at the outset of the scheme to avoid the environmental integrity of the scheme being compromised.

It is proposed that the scheme apply a civil penalty for non-compliance, underpinned by a provision to publish the names of participants that are not in compliance. Should non-compliance become an issue in the future, and a greater deterrent become required, then a criminal sanction could be considered at some future time.

A penalty level has not been determined at this stage. It will be set once the scheme cap and corresponding compliance costs have been determined (that is, following public consultation on the Discussion Paper and further modelling).

It is proposed that:

- *the penalty should be set a level that caps the cost of the scheme at an acceptable level but also encourages compliance*
- *a civil penalty should be applied for non-compliance.*

4.3 Make-good provision

A make-good provision, whereby scheme participants need to purchase permits to make up any shortfall in addition to paying the penalty, can provide an additional incentive (and cost) to ensure that the overall emissions cap is achieved.

Make-good provisions are not a feature of trading schemes operating in Australia. In contrast, the EU ETS design includes a make-good provision.

⁴⁴ Proposition 7 of the 10 key design propositions stated that a penalty should be set to encourage compliance and to establish a price ceiling for the permit market.

Similarly, in the United States, the SO₂ Allowance Trading and OTC Regional NO_x Trading Programs are designed to ensure that the cap is met, and they have one-to-one and three-to-one make-good provisions, respectively.

4.3.1 Stakeholder views

A number of submissions (mainly renewable generators and environmental groups) supported the inclusion of a make-good provision to preserve the environmental integrity of the scheme.⁴⁵ A number of those submissions also noted that if future international agreements were to involve binding quantity targets (such as those under the Kyoto Protocol), the use of a make-good provision would avoid the need for taxpayers to buy international credits to make up the difference in any shortfall.

The Centre for Energy and Environmental Markets (submission 59, p. 26) also argued that the absence of a make-good provision in the design of an Australian emissions trading scheme could raise some practical challenges to linking with the EU ETS. In particular, by adopting less stringent sanctions the Australian emissions trading scheme could put the environmental outcomes under the EU ETS at risk.

In contrast, several stakeholders⁴⁶ argued against a make-good provision on the grounds that it would increase the economic uncertainty of the emissions trading scheme. For example, Origin Energy (submission 52) argued that the penalty should be set to avoid shortfalls, and if compliance becomes a concern, governments could review the scheme parameters.

4.3.2 Assessment

It is not proposed to include a make-good provision. To do so would mean that the future cost of compliance would be uncapped. This would significantly reduce the certainty available to investors. It would also increase the risk of large, sudden impacts on the economy.

As discussed above, the environmental integrity of the scheme could still be maintained by setting a penalty that encourages compliance. The need for a make-good provision could also be revisited at the time of the proposed scheme review (Chapter 8) should compliance become a concern.

⁴⁵ Australian Conservation Foundation, World Wide Fund for Nature, Australian Wind Energy Association, Environmental Defenders Office, Renewable Energy Generators Australia, Hydro Tasmania, Insurance Australia Group, Western Australian Water Corporation, Total Environment Centre and Centre for Energy and Environmental Markets.

⁴⁶ Origin Energy, NSW Generators, AGL, International Power, NRG, and Loy Yang Market Management Company.

The absence of a make-good provision could present some potential challenges to a bilateral link with the EU ETS (Chapter 12). However, although it is acknowledged that bilateral linking may be desirable in the longer term, the principal objective of designing a NETS is to establish a strong domestic market that meets Australia's greenhouse aspirations at least cost. Additionally this issue could be addressed in any transition to bilateral linking.

It is proposed that the scheme should not include a make-good provision.

4.4 Conclusion

A rigorous compliance regime is critical to guaranteeing the integrity of any emissions trading scheme and is central to the enforcement of the imposed cap.

In designing a NETS it is proposed that a civil penalty be set at an appropriate level to cap the price of emission permits and the overall cost of the scheme at an acceptable level, and encourage compliance.

The proposed compliance regime strikes an appropriate balance between meeting the needs of the economy and the environment.
