



## Client Newsletter

# Carbon Tax: Impact on Government Contracts

May 2012

### Introduction

From 1 July 2012, Australia's largest carbon emitters will be required to pay for the carbon they emit. It is expected that these entities will pass on the cost of their carbon emissions to their customers who in turn, will seek to pass on the cost increases to their own customers.

In this newsletter, we briefly consider the nature of the carbon tax, the different ways in which a contractual price review clause might operate where a supplier wishes to pass on increased costs arising from the carbon tax and some issues you need to be aware of with respect to government contracts.

### What is the carbon tax?

On 8 November 2011, the Federal Government passed a package of bills to implement its clean energy and climate change policy. This package included the *Clean Energy Act 2011 (Act)* which is intended to encourage the use of clean energy by putting a price on carbon pollution.

From 1 July 2012, Australia's largest carbon emitters (referred to as 'liable entities' under the Act) will be required to pay for their carbon emissions.<sup>1</sup> It was initially expected that the carbon pricing mechanism (CPM) would affect approximately 500 of Australia's largest carbon polluters.<sup>2</sup> However, the Federal Government has recently revised its estimate to be closer to 400 emitters.<sup>3</sup>

### Summary

When the carbon tax commences on 1 July 2012, it is expected that organisations liable to pay the tax will attempt to pass the cost on to their customers.

Whether liable organisations and their customers can pass the cost of the carbon tax further down the supply chain will depend on the content of their supply contracts.

A well drafted price review clause will limit a government agency's exposure to carbon tax price increases. However, sharing the burden of the carbon tax with suppliers might prove to be a more commercially sensible solution.

For the first three years after the Act commences, the carbon price will be fixed, commencing at \$23 per tonne and increasing by 2.5% per year in real terms.<sup>4</sup> Liable entities under the Act will be required to purchase carbon permits for every tonne of carbon they produce.

From 1 July 2015, the CPM will convert to an emissions trading scheme that will place a cap on Australia's total carbon emissions. The price for carbon permits will be set by the market.<sup>5</sup>

## Who will be affected?

The CPM will directly impact around 400 liable entities required to purchase carbon permits to pay for their carbon emissions. Liable entities that must purchase carbon permits from 1 July 2012 include:

- power generators including Loy Yang, International Power and TRUenergy;
- mining companies, including BHP and Rio Tinto;
- heavy industry firms, including Alcoa;
- landfill operators including local councils and private waste management companies; and
- companies such as Crown Melbourne and La Trobe University because they generate their own electricity.<sup>6</sup>

It is expected that the costs of the permits to these entities will be passed downstream to purchasers in the supply chain from the top emitter to the ultimate consumer. This is expected to result in increases to the costs of electricity, waste management, fuel, raw materials and labour.<sup>7</sup>

## Existing contracts

### Passing costs downstream

A 'price review clause' in an existing contract may permit a supplier to pass on an increase in costs for the carbon tax. Price review clauses or 'pass-through costs clauses' in contracts should be closely examined to determine if the clause permits cost increases arising from the CPM (**CPM cost increases**) to be passed on to government and if so, whether there are any limitations as to how much can be passed on.

### *Changes in law*

Government contracts typically provide that cost increases attributable to a change in law may only be passed on where that change could not have been reasonably foreseen when the contract was made.

Depending on when the contract was signed by the parties, this may have the effect that CPM cost increases cannot be passed on, even where the contract contains a price review clause. Where a contract is made after the date the Act commences, it would be difficult for a supplier to claim that the implementation of the CPM is a change in law justifying a price increase.

### *Changes in tax*

While it is commonly referred to as the 'carbon tax', the CPM is not strictly a tax. Therefore, where a price review clause is linked to changes in the taxation regime, it will be necessary to determine if the clause has been drafted broadly enough to permit the supplier to pass on CPM cost increases. Where the clause is strictly limited to changes in the taxation regime, the customer is likely to be protected from CPM cost increases.

### *Increases in consumer prices*

The carbon tax is expected to increase consumer prices by an anticipated 0.7% over 2012/2013.<sup>8</sup> Where a price review clause is linked to increases in the consumer price index (CPI), this may permit CPM cost increases to be passed on to the customer.

### *Direct or indirect costs*

Where liable entities pass on CPM cost increases to their customers, those customers are *indirectly* affected by the CPM. Whether they in turn can pass on cost increases to their customers, depends on whether the relevant price review clause allows for indirect cost increases.

### *Costs of compliance*

Organisations are likely to incur costs associated with compliance with the CPM. A price review clause should therefore be examined to determine whether the supplier can pass on its CPM compliance costs.

## *Express provision for the CPM*

Existing contracts may already contain a price review clause that is drafted broadly enough to include CPM cost increases or perhaps expressly includes them. Even where this is the case, the clause should still be carefully reviewed to identify whether there are any limitations on the amount that can be passed on to the customer. For example, the parties may have agreed to share the burden equally or the customer may not be required to shoulder 100% of the burden.

## **What is the supplier entitled to claim?**

The *Australian Consumer Law* prohibits businesses from making false, misleading or deceptive claims about the price of services or goods. Businesses therefore cannot arbitrarily increase the costs of their services or goods and attribute the increase to the carbon tax.

Where a contract permits a supplier to pass on CPM cost increases, suppliers must be able to substantiate claims about cost increases being caused by the carbon tax. Otherwise, they risk incurring financial penalties of up to \$66,000 or court imposed fines up to \$1.1m.<sup>9</sup>

Documentation can be requested from suppliers to substantiate any claimed costs increases.

Where a business has been able to offset its CPM cost increases, for example through government compensation or free carbon permits, pass through costs to the consumer must reflect the offset.

## **How should government agencies respond?**

### *Where the contract permits CPM cost increases*

Contracts should include a price review clause that accurately reflects the parties' agreement as to the circumstances that will trigger a price review, and which party/ies will bear any increase in costs arising in those circumstances, and to what extent.

Where an existing contract permits CPM cost increases to be passed on to a government

agency, the agency should confirm that the increase is legitimate and falls within the limits of the price review clause. In these circumstances, the government party to the contract is likely to be contractually bound to pay the increased costs.

Even where the agency is contractually bound to pay the increase, it could still seek a variation to the terms of the contract to lessen the impact of the CPM. The agency might agree for example to accept the increases up to a certain date with CPM price increases beyond this date being shared between the parties.

Assessing whether it is worth seeking a variation requires balancing the effort and expense of seeking, negotiating and drawing up a variation against the likely impact of the cost increase on the service or goods to be supplied. If the financial impact is minimal, because for example the increase in costs is small or the contract will expire within a short period after the commencement of the CPM, it may not be worth the trouble and expense of seeking the variation.

### *Where the contract does not permit CPM cost increases*

An existing contract with a supplier may not expressly permit the supplier to pass on CPM cost increases to the government agency. However, refusing to accept legitimate cost increases may not necessarily achieve the best outcome for the agency.

It is important to consider whether requiring a supplier to shoulder 100% of the costs may negatively impact an important relationship or cause the supplier to achieve savings elsewhere and thereby compromise the quality of their product or service.

There is also a risk that the supplier may not be willing to shoulder the burden and may therefore commence legal proceedings, justified or not, or seek other means of redress such as writing to the Minister or running to the media.

If the agency's capacity to resist an increase in costs would affect a supplier's viability, this too may provide a reason for the agency to shoulder some of the burden.

## Negotiating new contracts

Government agencies can limit exposure to CPM cost increases by including a price review clause in an agreement. This clause should specify the circumstances which will trigger the review and how cost increases will be apportioned between the parties.

For long term contracts that are of significant financial value to government the contract should make provision for any price review mechanism to be reviewed at regular intervals. This may be particularly useful as the CPM transitions from the fixed price period to the emissions cap and trading scheme in 2015.

## Impact of the carbon tax on particular agreements

### Construction contracts

The CPM is expected to increase the costs of building and construction due to increases in the costs of power and energy intensive construction materials.

The contractor's ability to pass-through these increases will depend on how payment is structured under the contract, ie a contractor is likely to be able to pass on such increases if the contract is on a 'costs plus' basis, but not if the contract provides for payment of a lump sum or according to a schedule of rates. Construction contracts may also contain clauses dealing with allocation of liability for rates and taxes or increased costs resulting from changes in legislative requirements. Depending on how the clauses are worded, they may provide scope for costs increases due to the CPM to be passed through.

All current construction contracts and tenders should be reviewed to determine whether the contractor is able to pass through cost increases resulting from the CPM.

## Lease agreements

The CPM is expected to result in increases to the costs of power and waste management. Increases in municipal rates are also likely subject to a local council's energy consumption and contribution to landfill. The consequent impact for landlords and tenants is obvious.

### *Government agency as tenant*

Government agencies entering into a lease agreement as a tenant are required to use one of four standard leases.<sup>10</sup> The form of lease depends on whether the agency is leasing whole or part of a building and whether it is agreeing to pay rent only (gross lease) or rent and a contribution to the outgoings (net lease).

Where an agency has entered into a gross lease, the agency's exposure to CPM cost increases is limited. Conceivably, a landlord could increase the rent to recoup CPM cost increases where the lease's rent review provisions so permit. Otherwise, an agency's exposure will most likely arise directly through its agreements with utility companies.

Where an agency has entered into a net lease, the Tenant must pay Rates and Taxes which, as defined in the lease, will expose the agency to CPM cost increases. The agency will also be directly exposed through its agreements with utility companies.

### *Government agency as landlord*

Where a government agency enters a lease agreement as landlord and the tenant is leasing the whole of the land or premises the subject of the lease, generally the agency will enter into a net lease. Under the VGSO's standard net lease agreement, the tenant is required to pay Rates and Taxes and all Outgoings for the property, terms which are broadly defined within the standard net lease agreement. As a result, the agency is likely to be protected from CPM cost increases.

Where the tenant is leasing only part of the premises, for example, one floor in a multi-storey building, the lease agreement will require the tenant to pay a pro rata amount of the total Rates, Taxes and Outgoings for the entire premises. Therefore, the landlord agency will be protected from CPM cost increases to the extent of the tenant's pro rata liability.

When negotiating lease terms, Government agencies should take account of CPM cost increases in considering whether to depart from the position in the standard net lease agreement.

## Further information

For further information about your agency's exposure to CPM cost increases and for drafting and negotiating price review clauses in your contracts to deal with the implementation of the carbon tax scheme, please contact:

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<sup>1</sup> Australian Government, 'Clean Energy Future: An overview of the Clean Energy Legislative Package', [www.cleanenergyfuture.gov.au](http://www.cleanenergyfuture.gov.au), p 5.

<sup>2</sup> Ibid.

<sup>3</sup> David Wroe, 'Carbon tax hit list below expected 500 companies', *The Age* (online) 5 May 2012, <<http://www.theage.com.au/opinion/political-news/carbon-tax-hit-list-below-expected-500-companies-20120504-1y4h7.html>>.

<sup>4</sup> Above n 1.

<sup>5</sup> Ibid.

<sup>6</sup> Above n 3.

<sup>7</sup> 'Discussion Paper on Carbon Tax Impact on Government Goods and Services, and Construction' (Australasian Procurement and Construction Council, March 2012) 5.

<sup>8</sup> Above n 1, p 6.

<sup>9</sup> *Carbon price claims* (2012) Australian Competition and Consumer Commission <<http://www.accc.gov.au/content/index.phtml/itemId/1039030>> .

<sup>10</sup> 'Victorian Government Office Accommodation Guidelines 2007' p 17.