Australian Government

Department of Climate Change, Energy, the Environment and Water

Safeguard Mechanism

Earnings Before Interest and Tax (EBIT) Guidelines

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Contents

1. Defining and calculating EBIT

These guidelines are to be used for the purpose of applying for a trade-exposed baseline-adjusted (TEBA) determination in accordance with the *National Greenhouse and Energy Reporting (Safeguard Mechanism) Rule 2015* (Safeguard Rules). These administrative guidelines should be read consistently with the Safeguard Rules.

1.1. A Facility is defined under section 9 of the *National Greenhouse and Energy Reporting Act 2007* (NGER Act) and the regulations made under that section. In these guidelines "Facility" refers to the facility to which the TEBA determination relates to. The Facility boundary used to determine the EBIT must be the same as the Facility boundary used for reporting under the NGER Act.

1.2. The guidance provided in this document should only be applied to calculate a Facility level EBIT for the purpose of applying for a determination that the Facility is a TEBA facility. It must not be used for any other financial reporting obligations.

1.3. When applying to the Clean Energy Regulator for a determination that the Facility is a TEBA facility in a particular financial year (the first financial year) and the next 2 financial years, the responsible emitter must calculate their Facility's EBIT for the first financial year.

1.4. As per subsection 37(2) of the Safeguard Rules, the EBIT of a Facility for a financial year is to be calculated in accordance with Australian Accounting Standards (to the extent applicable) and as in force for the relevant financial year and any EBIT Guidelines that are in force at that time. For this purpose, the EBIT guidelines prevail over the Australian Accounting Standards to the extent of any inconsistency.

1.5. For the purpose of applying for a TEBA determination, a Facility's EBIT is defined as its revenue minus expenses with interest expense and income tax expense or benefit added back. The revenue and expense are those incurred by the Facility within its defined NGER boundary.

$$\boldsymbol{EBIT = revenue - expenses^{1} + interest\ expense + income\ tax\ expense\ or\ benefit}$$

1.6. The components of EBIT and the required calculation steps are outlined in Appendix A so as to provide guidance on how each component is calculated in accordance with these guidelines and the application of Australian Accounting Standard requirements. The different components of the EBIT proforma calculation are explained in section 3. For the avoidance of doubt each component of EBIT as outlined in Appendix A should be assessed and calculated (including nil amounts) as part of the TEBA application process.

[1] Expenses includes all expenses in the determination of earnings. This includes, but is not limited to operating costs, supplier costs, salaries and wages, interest expense, tax expense or benefit and depreciation and amortisation.

2. Auditing

2.1. TEBA status affords a significant benefit to facilities that acquire it. It is therefore essential that information provided to the Clean Energy Regulator passes an appropriate level of scrutiny. This ensures that determinations can be made with confidence and that support is provided to facilities that genuinely need it, while ensuring the Safeguard Mechanism's emissions targets are met.

2.2. Consistent with this, paragraphs 42(2)(b) and 40(3)(a) of the Safeguard Rules require that auditing of the EBIT figure must be done to a reasonable assurance level and that the audit report must include a conclusion whether, in all material respects, the information included in the application is correct. The audit of Appendix A must be performed in accordance with Australian Auditing Standards[2].

3. Components of EBIT calculations proforma

This section outlines what can and cannot be recognised under each EBIT component consistent with Appendix A.

3.1. Revenue from external customers

3.1.1. Revenue of the Facility from external customers (third parties)[3] should be calculated and recognised under AASB 15 *Revenue from Contracts with Customers* (AASB 15).

3.2. Revenue from other sources other than that recognised under 3.1.1

3.2.1. Transactions resulting in the transfer of goods and services to related parties (defined in AASB 124 *Related Party Disclosures*), whether the party is a legal entity or not, may not be typically recognised as revenue under AASB 15 due to their nature. However, they represent activities performed by the Facility that generate revenue from the perforce of activities (either the provision of goods or services) that are ultimately used in the provision of goods or services to external customers (third parties) and must be accounted for to enable the calculation of an EBIT at the Facility level, especially where revenue is not normally recorded.

3.2.2. Revenue from the undertaking of activities by the Facility not recognised under paragraph 3.1.1 needs to be determined and recorded as part of the calculation of EBIT. Such transactions should be accounted for at arm's length[4] as if they are transacted with an external customer (third party) under normal business commercial terms, as per paragraph 3.2.3 to 3.2.7, unless otherwise allowed by these guidelines. For example, the transfer of alumina from an alumina refinery to an aluminium smelter where the parties are related and the exchange would normally be non-monetary.

3.2.3. Where the Facility provides its product to an internal customer[5] for either direct sale or further processing and subsequent sale to a third party, the revenue to be recognised is equal to the market value for the goods or services produced and provided to the internal customer. Where an active market which is an appropriate proxy exists, the market value used for the determination of revenue should be made with reference to that active market for the sale of the relevant output.

3.2.4. Market value of the transferred goods must be derived from the average daily market price of the relevant active market (including any relevant commodity exchange) for all trading days within the first financial year from the most appropriate commodity exchange.

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[2] ASAE 800: Special Considerations—Audits of Financial Reports Prepared in Accordance with Special Purpose Frameworks would likely be the appropriate auditing standard to be applied.

[3] An entity which is not related to either the corporation which is responsible for submitting a report under the NGER Act for the relevant Facility or to any entity related to that corporation.

[4] The term "arm's length" is also utilised in subsection 3.4 dealing with calculation of direct costs using transfer pricing rules. The "arm's length" principle should be applied independently and consistently within each respective section.

[5] A customer which is not an external customer.

3.2.5. Where the market value of the transferred goods cannot be determined with reference to an active market, the revenue for the transferred goods is equivalent to the aggregate revenue generated by the sale of the final product to external customers (third parties), proportionally allocated to the Facility. This proportion should be based on the expense incurred in producing the intermediary good (required in the production of that product) compared to the total costs of producing the final product in its saleable form. For the purpose of clarity, the expenses determined for both the intermediary product and the final product must be in accordance with AASB 102 *Inventories* and should not include any markup on the transfer of intermediary product in the determination of the expense for the final product.

3.2.6. Where the Facility is a joint operation, the revenue for the Facility is the revenue generated by the sale of the output provided to the participants for sale to their respective customers.

3.2.7. In the rare circumstance that it is not practicable for a joint operation to determine its revenue in accordance with paragraph 3.2.6 (i.e. where confidentiality clauses prohibit the provision of such information to the responsible emitter for the Facility's TEBA application), the revenue to be recognised for the goods or service produced is to be determined in accordance with paragraphs 3.2.3 to 3.2.5.

3.2.8. It is envisaged that paragraphs 3.2.3 to 3.2.7 should address the majority of scenarios in which a Facility derives revenue from sales to internal customers or related parties. Where revenue cannot be appropriately calculated in accordance with paragraphs 3.2.3 to 3.2.7, either because the requirements of the paragraph are not met (for example, there is no active market) or because they do not result in a price which is reflective of an arms' length transaction, the responsible emitter must rely on accepted industry and professional understanding of the concept of an arm's length transaction in determining the revenue to be included in Appendix A.

3.2.9. The methodology used in determining and applying a revenue calculation approach outlined in paragraphs 3.2.3 to 3.2.8 for each product, including determining market value, must be provided to the auditor of the TEBA application. Each separate revenue stream need not apply the same methodology. The most appropriate methodology for the revenue stream is required to be determined and disclosed to the auditor for evaluation.

3.2.10. Where activities are physically undertaken at the Facility but are not part of the activity or series of activities that constitute the Facility (including ancillary activities), any revenue and the associated costs must be excluded from the calculation of EBIT. For instance, if a Facility provides payroll services for other entities or components of the broader group, the associated revenue and costs would not form part of the EBIT determination. Only those costs incurred in the provision of these services that relate to the Facility should be included in the EBIT determination.

3.3. Revenue and costs from third-party contractors

3.3.1. The revenue and costs of third-party contractors operating within the NGER boundary of the Facility must not be included in the calculation of EBIT.

3.4. Grant income

3.4.1. Grant income received that is directly attributable to the activities of the Facility including assistance for operating the assets of the Facility must be recognised as per AASB120 *Accounting for Government Grants and Disclosure of Government Assistance*.

3.4.2. Contrary to AASB 120, any funding provided for the financial year under the Powering the Regions Fund (PRF) must be excluded from the Facility's revenue for the financial year (where it is included in revenue or other income), as per subsection 37(4) of the Safeguard Rules. This ensures that funding received to support on-site abatement through the PRF does not work against the ability of a Facility to secure a TEBA determination.

3.4.3. Consistent with the intent of subsection 37(4) of the Safeguard Rules, grants received under the PRF, which have been recorded under AASB 120 as a reduction in the capitalised cost of the asset to which the grant relates, must have the impact of this grant reversed from the determination of depreciation for the purposes of the TEBA application. This will result in an increase in the depreciation for the particular asset in question.

3.5. Direct costs

3.5.1. Direct costs include all costs that are directly attributable to the activities of the Facility and must be included in the determination of Total Expenses in Appendix A. These include direct material inputs, work in progress, direct labour, depreciation of assets used for the production process, amortisation, interest expense and any other expenses such as consumables which are directly related to the activities performed by the Facility (e.g. electricity and water).

3.5.2. For all direct costs incurred by the Facility for the purchase of goods and services provided by related parties, where transfer pricing rules apply to those costs, the transfer pricing determined price is to be used for the expense recognition. Where such related party purchases are not directly covered by transfer pricing rules, the cost to be used in the determination of the EBIT is to be calculated using the same methodology as if transfer pricing rules applied.

3.5.3. Australia's transfer pricing rules do not prescribe any particular methodology or preference to arrive at an arm's length outcome for cross border transactions. The responsible emitter should seek to adopt the method that is best suited to the circumstances of each case and consistently apply to all such interactions.

3.5.4. Documentation must be kept to substantiate compliance in line with the documentation requirements of Taxation Rulings TR97/20 and TR2014/6. The methodology or methodologies used should be disclosed to the auditor for the TEBA application, with any changes in methodology applied in subsequent applications explained.

3.6. Indirect costs

3.6.1. Indirect costs are those costs that are required for the commercial operation of the facility and include management and administration activities that support the Facility in the production of the relevant goods and services. Costs to be included are at the discretion of the responsible emitter and must be agreed with the auditor of the TEBA application and included in the determination of Total Expenses in Appendix A.

3.6.2. Management and administration costs not required for the commercial operation of the Facility cannot be included in the EBIT calculation.

3.6.3. In circumstances where facility management and administration costs are delivered and incurred outside the Facility boundary (such as payroll services, marketing and sales), they must reflect appropriately the proportion attributable to the Facility using an appropriate allocation basis (for instance number of payroll runs or employees for a payroll service). Any such costs must be recorded at their incurred cost with no margin or markup. Interest expense or other financing costs such as borrowing fees, amortisation of borrowing costs and hedging costs must be excluded from any allocation.

3.6.4. Where they meet the requirements of Australian Accounting Standards, Safeguard Mechanism compliance costs can be included in the determination of EBIT in Appendix A. The compliance costs to be recognised are only those that are attributable to the first financial year[6]. As required by the Australian Accounting Standards, only one accounting methodology must be used to determine the

[6] This allows the responsible emitter to either recognise the cost of units surrendered in the first financial year, that is for the previous compliance period, or through the raising of a provision for the compliance costs for the first financial year.

compliance costs included in EBIT. The responsible emitter may apply a different accounting method in subsequent TEBA applications.

3.6.5. Where a provision is used in determining the compliance costs to be recognised in the first financial year, the compliance costs must reflect the expected impact of receiving the TEBA determination in accordance with paragraph 3.6.6.

3.6.6. The emissions reduction contribution (ERC) used to calculate the compliance costs included in EBIT must be reflective of the reduced real-world Safeguard obligation resulting from the granting of a TEBA determination. The relevant ERC is derived by calculating the assessed cost impact assuming a default decline rate for the calculation of compliance costs included in EBIT. The result of this assessed cost impact assessment must be in turn be used to calculate a new emissions reduction contribution that is used in the second iteration of the assessed cost impact calculation. This process must be repeated until the ERC obtained from the assessed cost impact calculation is unchanged for two consecutive iterations. This ERC and evidence of its calculation must be provided to the auditor of the TEBA application. Further guidance is provided in Appendix B.

3.7. Interest expense and tax expense/benefit

3.7.1. Interest expense,[7] and tax expense or benefit must be consistent with the boundary of the Facility, unless their allocation is not permitted by these guidelines. Where incurred at an aggregate level, these figures must be disaggregated and attributed in direct proportion to what is incurred by the Facility. These figures included in Expense will need to be adjusted and removed in the later section of the calculation as outlined in Appendix A.

3.8. Prior period adjustments

3.8.1. Prior period adjustments should be accounted for under AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors.* This represents adjustments from prior period due to errors or change of accounting policy due to a new accounting standard becoming effective and with retrospective impact. Any adjustment recorded in the TEBA application under these guidelines must be consistent with that applied in the audited financial statements of the Facility for the financial period being evaluated[8].

3.9. Impairment of assets

3.9.1. Impairment of assets should be accounted under AASB 136 *Impairment of Assets* and must be included as part of the calculation of Total Expense in Appendix A. Any adjustment recorded in the determination of EBIT under these guidelines must be consistent with that applied in the audited financial statements of the relevant Facility for the financial period being evaluated[9].

3.10. Depreciation and amortisation of assets

3.10.1. Depreciation and amortisation of the assets of the Facility should be accounted for under AASB 116 *Property Plant and Equipment* and AASB138 *Intangible Assets*. For any right-of-use assets used, the costs of these assets (mainly finance costs and depreciation) should be accounted for under AASB 16 *Leases*. These costs must be included as part of the calculation of Total Expense in Appendix A.

3.10.2. The determination of depreciation and amortisation of assets is to be based on the original cost base of the asset calculated in accordance with the Australian Accounting Standards. Revaluation of assets is not allowed.

[7] Interest expense includes, but is not limited to items such as interest expense incurred directly, borrowing costs and the amortization of borrowing costs, hedging expense or the allocation of group interest and borrowing and hedging costs to the Facility.

[8] Where the Facility does not have audited financial statements for the prior year, audited financial statements of the entity to which the Facility's results are included. These financial statements are to be in compliance with Australian Accounting Standards.

[9] Refer to Footnote 8.

3.10.3. The useful life of the assets included in the EBIT used in the first TEBA determination must be the same as that used in the audited financial statements for the previous year of the Facility[10]. These useful lives will be used for any subsequent TEBA applications and EBIT determinations unless there has been a change in useful life of assets which has been reflected in the relevant financial year's audited financial statements of the Facility[11].

[10] Refer to Footnote 8.

[11] Refer to Footnote 8.

4. Accelerated Depreciation

4.1. Applying accelerated depreciation

4.1.1. Consistent with subsection 37(5) of the Safeguard Rules, accelerated depreciation may be applied to the calculation of EBIT for a Facility by specifying a depreciation schedule with a depreciation factor of 1.0, 1.1 or 1.2 for each capital expense of the Facility. An asset located outside the Facility's NGER boundary cannot apply accelerated depreciation.

4.1.2. The accelerated depreciation factor used for a given asset is locked in for the period of that TEBA determination. To calculate the accelerated (TEBA) depreciation schedule for an asset, the asset's depreciation value used for accounting practices for that year is multiplied by the nominated depreciation factor. An example of this is provided in Box 1.

Box 1. Applying accelerate depreciation to an existing depreciation schedule.

Underlying BAU Schedule				TEBA Schedule			
Year	**Net book value (opening)**	**Depreciation expense**	**Net book value (closing)**	**Net book value (opening)**	**Depreciation factor**	**Depreciation expense**	**Net book value (closing)**
0			$100,000				$100,000
1	$100,000	$10,000	$90,000	$100,000	1.0	$10,000	$90,000
2	$90,000	$10,000	$80,000	**$90.000**	**1.1**	**$11,000**	**$79,000**
3	$80,000	$10,000	$70,000	**$79,000**	**1.1**	**$11,000**	**$68,000**
4	$70,000	$10,000	$60,000	**$68,000**	**1.1**	**$11,000**	**$57,000**
5	$60,000	$10,000	$50,000	$57,000	1.0	$10,000	$47,000
6	$50,000	$10,000	$40,000	$47,000	1.0	$10,000	$37,000
7	$40,000	$10,000	$30,000	**$37,000**	**1.2**	**$12,000**	**$25,000**
8	$30,000	$10,000	$20,000	**$25,000**	**1.2**	**$12,000**	**$13,000**
9	$20,000	$10,000	$10,000	**$13,000**	**1.2**	**$12,000**	**$1,000**
10	$10,000	$10,000	$0	$1,000	0.1	$1,000	$0

The BAU depreciation schedule assumes a straight-line depreciation.

$$\frac{[Starting\ asset\ value - salvage\ value]}{Useful\ life} = \frac{\$100{,}000 - \$20{,}000}{8} = \$10{,}000$$

The starting asset value for the TEBA depreciation schedule is the current carrying value of the asset. The TEBA Schedule table shows that the responsible emitter has secured two TEBA determinations in years 2-4 and 7-9, each with a different accelerated depreciation factor nominated for each period.

Applying accelerate depreciation is done by multiplying the product of the above formula with the nominated accelerated depreciation factor. For example, when applied for TEBA years 2 to 4, this results in a yearly depreciation of $11,000 for the three years of the TEBA determination.

$$\left(\frac{[Starting\ asset\ value - salvage\ value]}{Useful\ life}\right) \times\ depreciation\ factor \left(\frac{\$100{,}000 - \$20{,}000}{8}\right) \times 1.1 = \$11{,}000$$

4.1.3. The use of accelerated depreciation has the additional effect of exhausting usable depreciation within a shorter period than that used for accounting or taxation purposes and should not be taken as an indication that the depreciation schedule for other purposes should be shortened.

4.2. TEBA determination expiry and subsequent TEBA determinations

4.2.1. Following the expiry of a TEBA determination and the absence of a new determination, the depreciation value for that asset must be consistent with underlying audited financial statements. The carrying value of the asset must be consistent with the TEBA depreciation schedule, not the underlying audited financial statements.

4.2.2. In applying for subsequent TEBA determinations, calculation of the depreciation expense and the carrying value of the asset must take into account the rates of depreciation used in past TEBA determinations by using the TEBA depreciation schedule.

4.2.3. A new TEBA application for a determination to commence in a subsequent year would be able to nominate a different accelerated depreciation factor to apply in the new TEBA determination period.

Appendix A – EBIT calculation guidance

The below table is a proforma for the purpose of the application. The below information should be appropriately supported and information should be provided to the auditor.

EBIT Element	**Amount**	**Supporting document reference**	**Reference**
Revenue:			
Revenue from external customers			Subsection 3.1, AASB 15
Revenue from internal sources			Subsection 3.2
Other revenue:			
Interest income (C)			AASB 9
Grant income			AASB 120
Gain / Loss on sale of Property Plant and equipment			AASB 116
Gain / Loss on foreign exchange transactions			AASB 121
TOTAL REVENUE (A)			
Direct costs incurred:			Subsection 3.5
Suppliers			
Salaries and Wages			
Book depreciation and amortisation			AASB 116, AASB138
Accelerated deprecation included			Section 4
Interest expense (D)			AASB 9
Impairment of assets			AASB 136
Other expenses			
Indirect costs incurred:			Subsection 3.6
Suppliers			
Salaries and Wages			
Book depreciation and amortisation			AASB 116, AASB138
Accelerated deprecation included			Section 4
Interest expense (E)			AASB 9
Emissions Reduction Contribution used to determine compliance costs			Paragraph 3.6.6, if raising a provision.
Safeguard compliance costs			Paragraph 3.6.4 to 3.6.6
Other expenses			
Other allocated costs			Section 3
TOTAL EXPENSES (B)			
Tax expense / benefit (F)			If tax is not included in the total expenses, this item should be zero.
PROFIT AFTER TAX (G = A-B-F)			AASB 101
EBIT Determination (G+F+E+D-C)			

Appendix B – Provisions in the context of the TEBA framework

A responsible emitter wishing to raise a provision for Safeguard Mechanism compliance costs must derive the effective real-world liability assuming that a TEBA determination is granted. The provision for Safeguard Mechanism compliance costs must therefore be based on a baseline decline rate consistent with this, rather than a decline rate that would apply in the absence of the TEBA application, though that must necessarily be used as the starting point.

To determine the appropriate decline rate, the responsible emitter must repeat the assessed cost impact calculation by working out a new emissions reduction contribution (ERC) utilising the results from the previously calculated assessed cost impact. This process is repeated until the same ERC is obtained two consecutive times. This is the ERC that must be used to calculate the Facility exceedance and therefore Safeguard liability which forms the basis of the compliance costs. A simplified example of this is demonstrated below and it is assumed that all numbers are positive for the purpose of the formulas indicated.

Iteration 1

When determining the compliance costs included in EBIT in the first iteration of the calculation, the ERC that would apply for that compliance year without the TEBA determination in place, e.g. an ERC of 0.95100 in 2023-24, must be used as a starting point (ERC1).

$$Assessed\ cost\ impact = \frac{Exceedance\ @\ ERC1 \times Default\ Prescribed\ Unit\ Price}{EBIT - (Exeedance\ @\ ERC1 \times Unit\ Cost)}$$

Iteration 2

The result obtained from the assessed cost impact calculation in the first iteration is used to determine a second ERC (ERC2)[12]. This is achieved by calculating the ratio of cost impacts using the results from the first iteration of the assessed cost impact and in turn using this ratio of cost impacts to calculate ERC2.

$$Assessed\ cost\ impact = \frac{Exceedance\ @\ ERC1 \times Default\ Prescribed\ Unit\ Price}{EBIT\ - (Exeedance\ @\ ERC2 \times Unit\ Cost)}$$

Iteration 3

The process carried out in iteration 2 is repeated in iteration 3. The result of iteration 2 is used to calculate an updated ratio of cost impacts and a new updated ERC (ERC3) to be used in the third iteration of the assessed cost impact.

$$Assessed\ cost\ impact = \frac{Exceedance\ @\ ERC1\ \times Default\ Prescribed\ Unit\ Price}{EBIT - (Exeedance\ @\ ERC3 \times Unit\ Cost)}$$

This process must be continued until the same ERC is obtained for two iterations in a row.

[12] To be rounded to 5 decimal places (rounding up if the sixth decimal place is 5 or more).