



Draft Earnings Before Interest and Tax Guidelines Explanatory Document

Overview

This document provides additional information and context to understand the draft Earnings Before Interest and Tax (EBIT) Guidelines. EBIT Guidelines are an administrative document published by the Secretary under subsection 37(7) of the *National Greenhouse and Energy Reporting (Safeguard Mechanism) Rule 2015* (Safeguard Rules). The final EBIT Guidelines will assist the Regulator, applicants and auditors apply the calculations required by section 37 of the Safeguard Rules and are consistent with those rules.

The Australian Government reformed the Safeguard Mechanism in 2023 to help Australia meet its climate targets and to ensure Australia remains competitive in a decarbonising world. The reforms will reduce emissions at Australia's largest industrial facilities on a trajectory consistent with achieving Australia's emission reduction targets. The Safeguard Mechanism applies to facilities that emit scope 1 emissions of more than 100,000 tonnes of CO₂ equivalent in a year and sets legislated emissions targets, known as baselines, on the net greenhouse gas emissions of covered facilities. Baselines for facilities will decline by 4.9 per cent each year to 2030 in line with Australia's climate targets.

The reformed scheme is required to ensure that the competitiveness of trade-exposed industries is appropriately supported as Australia decarbonises. To support this objective, trade-exposed facilities¹ can apply to the Clean Energy Regulator (the Regulator) for trade-exposed baseline-adjusted (TEBA) status, which then provides a reduced baseline decline rate. Facilities are eligible to apply for a TEBA determination if their assessed scheme cost impact is above prescribed thresholds. This assistance has been designed so that it reduces compliance costs for facilities that genuinely need it while retaining an incentive to reduce emissions.

To qualify for TEBA status, manufacturing facilities are required to use scheme cost as a percentage of EBIT as a metric for cost impact, reflecting the value-added nature of their margins, and must demonstrate that it is equal to or greater than 3% of their EBIT. The adjustment of the baseline decline rate is commensurate to their cost impact, with a minimum decline rate of 1% being available to facilities where scheme costs are 10% or more of EBIT. The formula for calculating assessed cost impact for a manufacturing facility is provided in Box 1.

¹ A trade-exposed Facility is a facility whose primary production variable in the first financial year is a trade-exposed production variable. The term "Facility" is used to indicate a facility that is applying for a TEBA determination, rather than a general use of the term and is consistent with its application in the EBIT Guidelines document.

Box 1: Assessed cost impact

If a Facility is a manufacturing facility in a financial year, the assessed cost impact for the Facility for the financial year is the number worked out using the following formula:

$$P_{SM} \times PE / EBIT$$

P_{SM} is the number of dollars in the Safeguard Mechanism default prescribed unit price for the first adjusted financial year for the Facility.

PE is the number equal to the exceedance of the Facility.

$EBIT$ is the number of dollars that is equal to the earnings before interest and tax of the facility in the first adjusted financial year for the Facility.

Section 37 of the *National Greenhouse and Energy Reporting (Safeguard Mechanism) Rule 2015* (Safeguard Rules) sets out the definition of EBIT as outlined in Box 1 and provides principles regarding its calculation. It specifies that trade-exposed manufacturing facilities are required to calculate EBIT in accordance with the Australian Accounting Standards as in force at the end of the financial year and any EBIT guidelines in force at the time, with the EBIT Guidelines prevailing in the event of any inconsistencies.

EBIT is commonly reported within annual reports and other financial statements at a company level but is seldom reported at a facility level and is not a concept defined by the Australian Accounting Standards. Specific guidance is therefore required to enable the calculation of EBIT at a facility level. Subsection 37(7) of Safeguard Rule empowers the Secretary to make EBIT Guidelines and subsection 37(8) requires that these guidelines are to be published on the Department's website. These administrative guidelines seek to enable facilities to calculate a facility level EBIT in a way that does not advantage, or disadvantage facilities based on corporate or operational structure and does not impose undue burden. They are intended to be flexible and accommodate a wide variety of arrangements.

Calculating EBIT

Financial reporting boundary

To calculate EBIT at a facility level, the boundary of a Facility must be defined. The guidelines require that the financial information included in a Facility's EBIT is consistent with the activities that produce these emissions, in line with the Facility's *National Greenhouse and Energy Reporting Act* (NGER) boundary. The NGER boundary of a Facility forms the basis for its emissions reporting and determines the responsible emitter's liability.

The NGER Act defines facilities as an activity, or a series of activities (including ancillary activities), that involve greenhouse gas emissions, the production of energy or the consumption of energy that form a single undertaking or enterprise and meet the requirements of the regulations. Equating the Facility reporting boundary to its NGER boundary ensures that the EBIT only considers the revenue and expenses that are directly attributable to activities producing the emissions covered by the Safeguard Mechanism. The costs and revenue recognised are therefore an accurate reflection of the impacts of the scheme on the Facility and appropriately reflect the extent of any benefit received through a TEBA determination.

EBIT formula and period of calculation

EBIT is a measure of business profitability and at a basic level is the net income of a business undertaking. This is revenue minus the costs of production and capital used in the production process in the form of depreciation. The EBIT formula within the guidelines is defined as revenue minus expenses with interest expense and tax expense or benefit added back, as incurred through activities and ancillary activities undertaken by the Facility within its defined NGER boundary for the first financial year of a TEBA determination.

The terms of the proposed EBIT formula are accounting concepts consistent with Australian Accounting Standards. These standards are routinely used by companies preparing financial reports under the Corporations Act and are well understood by companies, accountants, and financial auditors. The formula incorporates interest expense and income tax expense or benefit to support transparency and ensures that interest and tax allocations are not inappropriately included within revenue and expenses. Consistent with the concept of EBIT, the interest and tax figures are removed from the final calculation as outlined in Appendix A of the guidelines.

EBIT components and inputs

The guidelines provided specific direction regarding what can and cannot be included under each component of EBIT and its constituent parts and is outlined in subsequent sections. Where this differs from the Australian Accounting Standards, the deviations have been made to ensure the integrity of the scheme and that facilities are not advantaged or disadvantaged based on their corporate structure. The Safeguard Rules also require that the EBIT figure is audited at the reasonable assurance level, as per Section 40 of the Safeguard Rule. It requires that the audit report accompanying the TEBA application includes a conclusion that the information included in the application is correct.

Revenue

Revenue is a primary business metric which shows the gross inflow of economic benefits and is the basis from which expenses are deducted to determine profit. Facilities maintain a clear and consistent measure of revenue which is a metric that is reasonably transparent and easy to obtain. To enable the calculation of EBIT, an equitable revenue figure must be attributable to a Facility arising from all activities within its NGER boundary. The guidelines capture all sources of revenue in two broad categories, revenue from contracts with customers and all other sources. This includes all revenue and costs from transactions with related parties, such as other operating segments within the same company.

Related party transaction are not always recorded or have direct revenue that can be easily attributable to the exchange. The guidelines provide direction for how such circumstances are to be handled and require that all dealings must occur as if engaging with an unrelated third party under normal business commercial terms, i.e. at arm's length. This helps to ensure goods and services are priced fairly and that revenue and corresponding costs are fairly reflected.

Where a Facility does not normally recognise revenue from external customers (for instance a Joint Venture where the produce is provided to the Joint Venture participants or their related sales agent), the revenue for the Facility is the revenue generated by the sale of the product provided to the related party for sale to their respective customers. Although the Facility producing the product does not record revenue, it is owned by the joint venture partners and therefore the revenue received by joint ventures for product sales is an accurate proxy for the revenue of the Facility. This is also consistent with the arm's length principle as it represents dealings with a third party.

In circumstances where the Facility provides the product to a related party for either direct sale or further processing and subsequent sale to a third party but does not generate external revenue and cannot attribute revenue, as outlined above, the revenue is equal to the market value for the goods or services produced. The use of market price is consistent with the arm's length principle as the prices are determined by transactions occurring between independent parties in an open market.

Where market value does not exist for a good or service, it is not possible to accurately determine an arm's length value. In such cases, the guidelines propose that revenue is recognised at cost through allocation to a Facility proportionally based on the percentage of its production costs to the total cost of producing the final product. For example, if a Facility provides an input into the production process of the final product and the costs of producing the input is 20% of the total cost of producing the final product throughout the length of the supply chain, the Facility producing the input would receive 20% of the revenue from the sale of the final product.

Revenue from grants

The guidelines require that any funding received through grants to be recorded as revenue as it represents a financial benefit that impacts the profitability of a Facility, with the exception of funding received through the Powering the Regions Fund (PRF), consistent with the Section 37(4) of the Safeguard Rule. The intent of the exclusion of PRF funding from revenue recognised under EBIT is to not discourage uptake of government support specifically aimed at Safeguard Mechanism covered facilities.

Direct and indirect costs

The manufacture of goods incurs both direct and indirect costs that comprise the expenses component of EBIT which is subtracted from revenue to determine profit.

Direct costs

Include all costs that are directly attributable to the operating activities of the Facility, such as material inputs, direct labour, utilities directly related to activities performed by the Facility and depreciation of assets used for the production process. Where transactions incurring costs occur with related parties outside Australia's borders, the guidelines require that Australian Taxation Office transfer pricing rules are applied, including record keeping to substantiate compliance.

Indirect costs

Relate to all indirect costs or overheads that can be allocated to the production process occurring at the Facility but are not immediately involved with production process, such as the management and administration costs required for its operation. In keeping with this principle, the guidelines allow for the allocation of corporate overhead costs where services, such as payroll are provided at an aggregate level. These must be proportional to the services received to accurately reflect the Facility management costs and prevent administration and management costs of other facilities from being captured, including broader management costs such as those related to Board management.

Depreciation, amortisation and impairment

Depreciation, amortisation, and impairment are included under direct costs, consistent with standard accounting practice and the concept of EBIT. Depreciation is the process of allocating the costs of tangible assets (such as plant equipment) on a yearly basis over the expected useful life of the asset, factoring in the decrease in value over time due to use and obsolescence. The depreciation of intangible assets, such as intellectual property, is known as amortisation. The guidelines also require that the responsible emitter use information provided in the audited financial statement for

the year prior to calculate their depreciation and amortisation. This ensures that relevant figures are accurate and are not adjusted for the purpose of securing a TEBA determination. Assets can also be impaired, which is where a one-off decrease in the value of an asset occurs to reflect changes in real world circumstances, such as a significant decrease in demand or major equipment failure. Impairment can occur in conjunction with depreciation and amortisation and has the effect of reducing the useful life of the asset.

Prior period adjustments

Prior period adjustments are allowed under the guidelines to ensure that the financial information provided by the Facility is accurate and in line with the latest accounting standards. There is a requirement for these adjustments to be consistent with the audited financial statements of the relevant entity for the financial period being evaluated to ensure they are not made for the purpose of securing a TEBA determination.

Accelerated Depreciation

Subsection 37(5) of the Safeguard Rule provides for use of accelerated depreciation whereby the normal yearly depreciation amount for an asset is multiplied by an accelerated depreciation factor. This has the effect of exhausting the usable depreciation of an asset more quickly, shortening its effective life from what would have been allowable under the Australian Accounting Standards. Accelerated depreciation arrangements will not affect the responsible emitter's normal financial reporting and are applied solely for the purpose of calculating EBIT for a TEBA determination.

The intention of this measure is to recognise that equipment may have a shorter effective life as industry transitions to net zero by 2050. It also reflects the capital-intensive nature of manufacturing facilities and provides an additional incentive for capital investment in these facilities, which is particularly important for activities to decarbonise production and replace existing assets with more efficient or lower emissions alternatives.

Consistent with the Safeguard Rule, the guidelines allow the responsible emitter to apply accelerated depreciation by nominating factors of 1.1 or 1.2 for each asset within their Facility's NGER boundary, effectively increasing the yearly depreciation amount by 10 and 20%, respectively. The responsible emitter may also choose to not apply accelerated depreciation by selecting a depreciation factor of 1.0 for a given asset. As the application for a TEBA determination only requires EBIT to be calculated for the first financial year, changing the accelerated depreciation factor can consequently only be achieved through re-applying for a TEBA determination in a subsequent financial year.

The guidelines require that the responsible emitter keeps a separate depreciation schedule for each asset they apply accelerated depreciation to (the TEBA depreciation schedule) to keep track of the asset's value consistently. This ensures that if the responsible emitter chooses to re-apply for a TEBA determination, the asset value does not revert to the higher value used for the Facility's normal financial reporting obligations which does not apply accelerated depreciation. This prevents the assets being overvalued.

The guidelines also require that a TEBA depreciation schedule applies the same accelerated depreciation factor during and following the TEBA determination period (unless changed in a subsequent determination), rather than revert to a factor of 1.0. This is logically consistent with the choice to apply accelerated depreciation, as the circumstances for which accelerated depreciation is allowed under the scheme are likely to persist into the near future.