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John Krbaleski
Principal Policy Officer
Department of Infrastructure
Level 23, 80 Collins Street
MELBOURNE VIC 3000

1 February 2006
Re: *Driving Investment in Renewable Energy in Victoria*

Dear John

AGL welcomes the opportunity to comment on the Driving Investment in Renewable Energy in Victoria Issues Paper. AGL believes that increasing the immediate uptake of renewable energy will provide for significant emission cuts in the future.

AGL is a strong supporter of renewable energy. As you would be aware, AGL recently purchased the renewable energy assets of Southern Hydro. Around 40% of AGL's generation portfolio is now comprised of zero emission generation capacity. In addition, we are also providing innovative retail solutions for our customers such as Green Energy.

Please find enclosed AGL's submission on the Issues Paper. Should you require further information, please contact Tim Nelson, Manager Environment Policy and Strategy on (02) 9921 2516 or by email at tanelson@agl.com.au.

Yours sincerely

Mary Darwell
Manager
Group Environment

AGL SUBMISSION ON DRIVING INVESTMENT IN RENEWABLE ENERGY IN VICTORIA ISSUES PAPER

1. Introduction

AGL is a leading energy company, with significant electricity and gas customer bases in Victoria, South Australia and New South Wales. AGL also owns gas and electricity distribution networks and a number of electricity generation assets including Loy Yang Power (minority investment), the Somerton peaking power station in Victoria and the Hallett peaking power station in South Australia. In addition, AGL recently acquired the zero emission assets of Southern Hydro (hydro and wind).

AGL supports cost effective initiatives designed to increase the uptake of renewable energy in Victoria. However, it is critical that increases in wholesale energy costs are factored into regulated retail energy prices. If regulated retail energy prices are not adjusted, retail competition will be undermined.

Although AGL would prefer a national approach to renewable energy policy, AGL supports the Victorian Government objective of increasing the proportion of renewable energy consumed in Victoria. Increased use of renewable energy will significantly reduce greenhouse gas emissions.

2. Reducing Emissions and Promoting Renewable Energy

AGL is a strong supporter of renewable energy. Around 40% of AGL's generation portfolio is zero emission and there are a number of new renewable energy projects in development. However, while renewable energy policy is important, the most effective policy for reducing greenhouse gas emissions is a broad-based national emissions trading scheme.

A national emissions trading scheme (ETS) allows the most cost-effective emission reduction projects to be developed. At present, there are many cost effective forms of reducing emissions which would be adopted before renewable energy. For example, combined cycle natural gas electricity generation has an emissions intensity of around 0.4 tonnes per MWh, almost one tonne per MWh lower than the current market average.

To achieve deeper cuts in emissions required in the medium to longer term, new renewable or low emission technologies are required. Therefore, developing renewable and low emission technologies is an important policy objective in its own right. AGL believes that the proposed 10% renewable energy target and brown coal innovation funding are sensible strategies for further developing these important technologies.

AGL supports the Government's objectives in establishing the scheme. In particular, AGL supports the Government's objective of developing a sustainable renewable energy industry within Victoria. To ensure that this policy initiative supports Victorian industry, a mechanism will need to be included that ensures that projects are actually built in Victoria.

3. Consistency with Commonwealth MRET

As an overriding policy design principle, AGL believes that the State-based scheme should be designed so that it is as similar to MRET as practically possible. While the Victorian target will differ from the Commonwealth target, aligning the regulatory mechanisms and infrastructure (such as regulators, certificates, registries etc) would significantly reduce compliance costs.

Ideally, the type of renewable generation that is eligible under MRET should be eligible under the Victorian scheme. However, to ensure instrument price levels required to achieve commerciality for new Renewable Energy projects developed within Victoria, existing generation capacity that is currently producing Renewable Energy Certificates under MRET should not be eligible under the Victorian scheme.

Therefore, only generation (including upgrades) developed after 1 July 2006 should be eligible under the Victorian scheme. To ensure additionality, this generation should only be

able to create either a Victorian Renewable Energy Certificate (VREC) or a Renewable Energy Certificate (REC) but not both. Retailers would then be required to purchase RECs to meet their MRET obligation and VRECs to meet their Victorian scheme obligation.

4. Start Date

AGL believes that the scheme should be implemented as soon as possible. The proposed target would require a number of new renewable energy projects to be operational by 2010. As much time as practically possible should be allowed for these projects to be developed. This is particularly important in light of the Government's assertion that the planning process will not be waived or compromised to allow the target to be met.

By establishing the scheme as soon as possible, the Government will be able to gradually increase the renewable target from current levels to 10% in 2010. If the scheme is not introduced as soon as possible, it will provide less time for projects to be developed and in place for operation in 2010. If implemented in 2007, projects can be completed in stages to provide market liquidity and stable pricing.

It is important that the scheme be as close as possible in design and operation to the current Mandatory Renewable Energy Target. Establishing unique systems and procedures within a retail business takes significant amounts of time and resources. A key way of ensuring that the scheme is able to commence as soon as practically possible is to align the required procedures and processes with those required under MRET.

However, as the details of the scheme are still to be finalised and established through legislation and regulation, it is unlikely that the scheme could be operational until 2007. In this context, AGL supports the proposed start date of 1 January 2007.

5. Target Level

The Victorian Government has outlined that it is committed to increasing the proportion of electricity consumption from renewable sources to 10% by 2010. However, it should be noted that between now and 2010, electricity demand is likely to increase. As such, forecasting the quantity of electricity consumption in GWh in 2010 is a difficult task.

AGL recommends that the Victorian Government adopt a ramp-up of fixed GWh targets so that the 2010 target is set with the objective of achieving the underlying 10% goal. This would provide certainty for investors, retailers and project developers and minimise the overall cost of compliance. The Government should aim to publish the target ramp-up with maximum lead time to maximise the functionality of a VREC market.

If a GWh target is not established, the overall cost of meeting the target is likely to be higher. The risk associated with forecasting potential liabilities will result in a risk premium being added to the cost of projects.

To minimise the risk associated with the nominated GWh figure diverging significantly from a 'real' 10% target, it would be appropriate for the Department of Infrastructure to undertake detailed work to identify the most likely demand growth scenario. This work could be done in consultation with industry through an Industry Consultation Group.

6. Interim Targets

AGL supports the use of linear interim targets. The alternative approach outlined in the Issues Paper is very complicated and would involve judgements about smoothing investment over a short timeframe. Linear interim targets are relatively simple and allow for a staged approach to project development. Appropriate banking and borrowing arrangements have been proven as an effective mechanism to provide flexibility for market participants to ensure that interim targets are notionally met.

7. Technology Neutral or Portfolio Approach

In keeping with the overarching policy design principle of consistency with MRET, AGL believes that a technology neutral approach is preferable. A portfolio-based approach is likely to result in higher compliance costs as least cost technologies may not be utilised.

The overall objective of the scheme should be to encourage the development of the Victorian renewable energy industry. If the policy provides explicit support for particular types of renewable energy, investment in research and development is likely to be distorted towards those technologies.

To minimise administration and compliance costs, AGL believes that the same criteria for creating Renewable Energy Certificates should be used to determine eligibility under the Victorian scheme. However:

- To ensure additionality, one MWh of electricity production used to create a Renewable Energy Certificate under MRET should not also be able to be used to create an equivalent certificate in Victoria.
- To ensure that existing contractual arrangements are not impacted and new renewable generation is developed in Victoria, only new generation (including upgrades above a new nominated baseline) should be eligible to create either a Renewable Energy Certificate or its Victorian equivalent. This effectively means that a baseline of 1 July 2006 should be set. If this is not put in place, there would be scope for existing renewable generators to allocate their generation away from MRET to the Victorian scheme. This would create extra demand for new eligible MRET projects which may be built outside Victoria.

8. End Date

When considering the most appropriate end date for the scheme, there are two important factors to consider: the length of time required for renewable energy projects to earn a positive rate of return; and the target for beyond 2010.

Renewable energy projects typically require a payback period of at least 15 years. This is because ongoing revenue streams are required to cover financial obligations associated with high levels of up-front capital costs. If the scheme is relatively short-lived (i.e. an end date before 2025), the cost of compliance will be higher. This is because developers will require higher revenues during a shorter time period to generate a positive rate of return on their investment. As such, AGL believes that the scheme should be in operation until at least 2025. If the end date chosen for the scheme is beyond 2025, consideration should be given towards resetting individual baselines once the economic life of specific projects is exhausted and refurbishment is required.

If the scheme is to be in operation until 2025, consideration needs to be given to the target beyond 2010. There are three main options:

- Fixed GWh Target: If the target remains fixed in GWh terms, no new projects will be developed as sufficient generation capacity will be in place to meet the target.
- Real 10% Beyond 2010: If the target is increased year on year to ensure that it represents a 'real' 10%, a very small number of projects may be built to gradually meet additional demand.
- Increasing Target: If the target is increased beyond a real 10%, a larger number of projects will be built to meet additional demand.

Given that international and domestic policy settings may have changed by 2010, AGL believes that the target should remain a 'real' 10% beyond 2010. As international and domestic policy settings become clearer, a decision on increasing the target beyond 2010

can be made. Again, the Government should aim to publish targets with maximum lead time to maximise the functionality of a VREC market.

An important issue that is not addressed in the Issues Paper is the potential for the market to be 'oversupplied' with renewable energy. The market created as a result of the Victorian 10% scheme is an artificial market. The certificate price in this market will be determined by the demand for renewable energy (driven by consumer demand and the need to comply with the target) and the cost of meeting this demand (i.e. technology costs). If additional policies or drivers result in additional renewable energy projects being built but there is no corresponding increase in the target, prices could fall below 'break-even' levels.

As discussed in other sections, pre-2006 generation capacity that is currently producing RECs should not be eligible under the Victorian scheme. AGL believes that this criteria should be applied for the life of the Victorian scheme. This is particularly important given that the end date of MRET (2020) is different from that proposed under the Victorian scheme (2025).

9. Liable Parties

Retailers and wholesale purchasers of electricity in Victoria are liable parties under MRET. To meet their obligations, they are required to purchase sufficient Renewable Energy Certificates and surrender them to the Office of the Renewable Energy Regulator. To minimise compliance and administration costs, AGL believes that this approach should be used for the Victorian scheme.

However, it is crucial that retail price regulation be adjusted to ensure that full cost pass through is permitted. If regulated tariffs are not adjusted to reflect the cost of meeting this renewable energy obligation, there is likely to be a significant reduction in competition in the retail market. Furthermore, prices will not be cost reflective. As a consequence, consumers will have no incentive to respond to price signals and adjust their behaviour accordingly.

10. Eligible Generation and the Creation of Certificates

In order to maximise consistency with MRET, AGL believes that the scheme should adopt the same list of eligible renewable energy sources and the same criteria for creating certificates. However, there are two additional criteria that should be satisfied:

- To ensure additionality, a generator that meets the criteria under MRET to create Renewable Energy Certificates should be able to create Renewable Energy Certificates or the Victorian equivalent (e.g. VRECs) for each MWh of energy produced. This will create two distinct markets and prevent the Victorian scheme significantly impacting on the market price of MRET Renewable Energy Certificates.
- A baseline of 1 July 2006 should be set for renewable generation (including upgrades) that can create either RECs or VRECS. If this is not put in place, there would be scope for existing renewable generators to allocate their generation away from MRET to the Victorian scheme. This would create extra demand for new MRET projects which may be built outside Victoria. Such an outcome would be entirely inconsistent with the Government's objectives.

If the MRET criteria is not used, it will become increasingly difficult to administer the scheme. This will add to compliance and administration costs which will increase energy prices. However, consideration needs to be given to the interaction between eligibility and the target. Based on current projections, it is unlikely that significant new renewable capacity will be built in Victoria to meet requirements under MRET. Therefore, the 10% target for the Victorian scheme should be set so that it allows for existing projects. If there is currently X GWh of renewable generation being produced, the target should be 10% of 2010 demand minus X GWh.

All new renewable generation that would be permitted under MRET should be eligible for the Victorian scheme if it is not used to create RECs. Specifically, upgrades to existing generation

facilities and efficiency improvements that are eligible under MRET should be included. Excluding these facilities would increase the cost of complying with the scheme.

AGL does not believe that the scheme should consider other policies and existing government support. Existing Government support for renewable energy development generally involves research and development assistance. Excluding technologies on the basis that they have previously received government support could result in a large number of technologies being excluded from the scheme.

In the context of the Victorian renewable energy proposal, AGL does not support including low emission technologies. Reducing emissions is best pursued through a broad based emissions trading scheme. It is unclear what threshold would be set to define 'low emissions'. The purpose of a renewable energy target is to provide industry development assistance. For broader emission reduction purposes, a low emissions target or emissions trading scheme is more suitable. AGL would prefer such a scheme to be implemented nationally.

11. Shortfall Charge

AGL supports the use of a shortfall charge to encourage compliance. A shortfall charge also effectively caps the cost of the scheme which provides certainty for investors and consumers. To maintain consistency with MRET, AGL is not opposed to a \$40 per MWh shortfall charge in the first year of operation. While consistency with MRET is desirable, a different shortfall charge is unlikely to create significant inefficiencies or additional costs. Therefore, AGL is not opposed to the charge being indexed over time to reflect changes in the overall price level (inflation).

It should be noted however that the prices required to economically construct renewable generation differ from State to State for various reasons, including the raw resource and the underlying electricity prices within the Node. This is demonstrated by the types and location of projects built to meet MRET to date. It is therefore likely that the certificate price envisaged for the Victorian scheme will need to be somewhat higher than the broader MRET scheme.

12. Banking and Borrowing

AGL supports the use of banking and borrowing arrangements. To minimise compliance and administration costs, AGL supports the use of the arrangements currently in place for MRET:

- Liable parties should be able to bank surplus certificates for use in a later compliance period. This provides flexibility for market participants and increases market liquidity. Banking also allows liable parties to manage the risk associated with forecasting their share of the overall target.
- Liable parties should be able to borrow from the following years target if they are within 10% of their target. This provides flexibility for market participants without compromising the integrity of the scheme (because a shortfall in a particular year is added to the following years target).

13. Administration

Ideally, the scheme should be administered by existing institutions such as the Office of the Renewable Energy Regulator (ORER) and the Essential Services Commission. Where possible, administration of the scheme should be carried out in parallel with MRET. This minimises compliance and administration costs.

The State Administrator should be responsible for administering and enforcing legislation, annual audits, determining individual participant liabilities, monitoring performance of the scheme, retiring certificates and monitoring compliance of liable parties. To minimise administration costs, the functions of the State administrator should be incorporated into an existing agency or regulator (e.g. Essential Services Commission).

The accreditation of generators and validation of certificates should be undertaken by ORER. Ideally, ORER would simply mark each certificate as either a REC or a VREC (Victorian Renewable Energy Certificate). Compliance with MRET would continue to be monitored as it is now. However, rather than ORER accepting the surrender of VRECs, a liable party would simply have an additional account within the REC registry (as in the case of Green Power). ORER would simply inform the State administrator how many VRECs each liable party has in their separate account at the end of each compliance period.

If ORER is not able to fulfil this function, two options have been identified by AGL:

- A completely separate certificate accreditation and validation process and registry could be established and run in parallel by the State administrator. Generators would only be eligible to create Victorian renewable energy certificates if they can demonstrate that they have not created RECs for the same generation. This option is not supported by AGL because of the substantial administration costs that would be incurred.
- The State administrator could require retailers to demonstrate that they have accumulated sufficient RECs to meet their requirements. These RECs would then be voluntarily surrendered to ORER. Assuming that ORER is not permitted to be formally involved, this option is preferred by AGL.

14. Potential to Transition into a National Scheme

The potential to transition into a national scheme should be an overarching objective as the scheme is being designed. However, any transition must consider the impact of merging the single State scheme into a broader national scheme. By merging schemes, the premium required for projects to be built in Victoria is effectively diluted.

15. Managing Economic Impacts

It is crucial that any additional wholesale energy costs created as a result of this policy are incorporated into regulated retail tariffs. Competition in the retail market will only occur if regulated tariffs reflect the underlying cost of energy supply. Furthermore, customers are better placed to use energy more efficiently if they are receiving appropriate price signals.

In a competitive market, each retailer will be free to contract in the most efficient way to minimise price increases for their customers. To maintain market share, each retailer will be incentivised to limit potential price increases by procuring the lowest cost renewable energy projects available.

However, where prices do increase, AGL supports action taken by Government to provide assistance to energy intensive industries. In addition, AGL is prepared to work with Governments to address hardship in the residential sector.