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Victorian Energy Efficiency Target Scheme
c/o Department of Primary Industries
Level 23
80 Collins Street
MELBOURNE VIC 3000

18 May 2007
Re: Victorian Energy Efficiency Target Scheme

Dear Sir or Madam

AGL welcomes the opportunity to provide comments on the Victorian Energy Efficiency Target Scheme Issues Paper.

AGL believes that there is significant potential for energy efficiency to deliver two important policy objectives: economic efficiency and reduced greenhouse gas emissions. However, it is important that any policies implemented achieve the lowest possible transaction costs to ensure community welfare is maximised.

Enclosed is AGL's submission that addresses these issues. Please contact Tim Nelson, Manager Carbon and Renewable Strategy, on (02) 9921 2516 if you have any queries regarding this submission.

Yours sincerely

Sean Kelly
General Manager
Energy Regulation

AGL SUBMISSION ON THE VICTORIAN ENERGY EFFICIENCY TARGET SCHEME ISSUES PAPER

EXECUTIVE SUMMARY

- AGL supports cost effective policies designed to increase uptake of cost effective energy conservation.
- A broad-based national emissions trading scheme is the most appropriate policy for reducing greenhouse gas emissions and will provide added economic incentives for reducing energy consumption. Emissions trading, rather than energy conservation policies should be used to address greenhouse gas emissions.
- Energy efficiency policies are appropriate for overcoming the barriers to the uptake of economic measures for reducing energy consumption. These barriers include high transaction costs; behavioural and institutional factors and regulated retail energy pricing.
- The Victorian Energy Efficiency Target Scheme is not the most cost effective and appropriate policy for deploying efficient energy savings projects. In its current form, the scheme does not meet the criteria outlined in the Issues Paper: efficiency; simplicity; flexibility; and effectiveness.
- Retailers are not the most appropriate point of liability for the proposed scheme. Distribution network operators which have a fixed geographical customer base are better placed to measure and verify consumption reductions.
- A more appropriate policy model is the NSW Energy Savings Fund. This policy is more appropriate for meeting the criteria outlined in the Issues Paper.
- It is important that policies are designed which overcome the key institutional barriers preventing the uptake of cost effective energy conservation measures. These policies include the removal of retail price regulation; minimum performance standards; regulation (e.g. phase out of incandescent light globes); and appropriate building standards.

AGL SUBMISSION ON THE VICTORIAN ENERGY EFFICIENCY TARGET SCHEME ISSUES PAPER

1. Introduction

AGL Energy (AGL) is Australia's leading energy company. We operate across the supply chain and have investments in energy retailing, coal-fired electricity generation, gas-fired electricity generation, renewables and upstream gas extraction. The diversity of this portfolio has allowed AGL to develop a detailed understanding of energy efficiency.

AGL is Australia's largest retailer of gas and electricity with 4.1 million customers in New South Wales, Victoria, South Australia and Queensland. AGL has significant investments in upstream energy markets. We own and operate 645 MW of hydroelectric power generation assets, the 1280 MW Torrens Island Power Station and the Somerton gas-fired power stations. AGL also has a 32.5% equity investment in the Loy Yang A power station.

AGL is developing a number of new energy assets. It is important to note that all of these assets are consistent with a carbon constrained future. The assets in development include Hallett wind farm (95 MW), Bogong hydro power generator (140 MW), Hallett gas-fired power station expansion (250 MW), Townsville gas-fired power station (370 MW), Victorian wind farm sites (400 MW) and Leaf's Gully gas-fired power station (300 MW).

Set out below are AGL's views on issues raised by the Issues Paper.

2. Energy Costs and Market Failure

Energy costs represent only a small proportion of average weekly household expenditure. This relatively small proportion of expenditure limits the incentive for users to consume energy efficiently. AGL agrees with the Productivity Commission's assessment that as energy usage increases as a proportion of total costs, the incentive for energy efficiency increases.

It is important to define energy efficiency accurately before considering energy efficiency policy measures. AGL considers energy efficiency to be the efficient use of energy – that is usage which occurs where the marginal cost of consumption equals the marginal benefit to the consumers. Energy use is only inefficient when the cost of using energy is higher than alternatives which provide the consumer with same level of utility at a lower overall cost. The most common causes of energy inefficiency are: regulated pricing which prevents allocative efficiency (efficient pricing); high transaction costs; and behavioural barriers.

In *The Private Cost Effectiveness of Improving Energy Efficiency*¹, the Productivity Commission identified a range of barriers to the uptake of energy efficiency. These include asymmetric information, split incentives, implementation costs, bounded rationality, organisational barriers and capital constraints. AGL believes that there are significant opportunities for making energy use more efficient where barriers such as these occur. Governments, industry and consumers all have a role to play in making energy use more efficient.

Programs aimed at increasing energy efficiency have two main benefits:

- Economic efficiency. If businesses and consumers are using energy inefficiently, there is scope for producing more output using the same amount of energy. Over time, this could contribute to significant additional economic growth.
- Reduced greenhouse gas emissions. Where overall energy consumption is reduced through appliance standards and the like, greenhouse emissions are likely to be reduced.

¹ <http://www.pc.gov.au/inquiry/energy/finalreport/energy.pdf>

AGL believes that the focus of energy efficiency policies and programs should be on economic efficiency. Greenhouse gas emissions should be addressed through a national greenhouse gas emissions trading scheme. However, when energy efficiency policies are being developed, there should be explicit consideration of the likely greenhouse impacts.

3. Cost Reflectivity and Energy Market Reform

AGL believes that retail energy price regulation limits the development of retail products and services which encourage more efficient behaviour by consumers. The incentive for customers to use energy more efficiently is increased when energy prices reflect the total cost of supply. Accordingly, AGL supports the Productivity Commission's recommendation that retail electricity and gas prices be deregulated.² It is important to note that this recommendation has been adopted by CoAG and through the Australian Energy Market Agreement signed by the State and Commonwealth Governments.

4. Energy Efficiency Policy and Greenhouse Gas Emissions

AGL recognises that climate change is a critical issue facing all countries. AGL accepts the scientific consensus that greenhouse gases in our atmosphere need to be stabilised at concentrations below 550 parts per million so as to avoid 'dangerous' climate change. Based upon this principle, AGL believes that policies should be developed internationally and nationally that place Australia on a pathway of reducing its greenhouse gas emissions in a way that is compatible with this objective.

The AGL Greenhouse Gas Policy supports the establishment of a long-term greenhouse gas emissions reduction target for 2050 and the creation of a broad based emissions trading scheme to achieve this goal. Notwithstanding current uncertainties, AGL believes that a prudent approach is to internally cost carbon in current business decision making.

It is important that governments focus on all sources of greenhouse gas emissions. In Australia, this should include stationary energy, transport, agriculture, industrial emissions and waste. Policies should be developed which allow for reductions in all of these sectors. AGL does not necessarily believe that each sector should be covered by emissions trading or another single policy. However, policies should be established to ensure that overall emission reduction requirements are fairly distributed across these sectors.

AGL is concerned that policies designed to reduce energy consumption may not be the most appropriate for addressing rising greenhouse gas emissions. A broad based national emissions trading scheme which places an appropriate price on emissions is the most appropriate way of internalising the costs associated with rising greenhouse gas emissions. Other policies 'pick winners' and may involve significantly higher costs than pursuing other forms of abatement (e.g. renewable energy deployment, fuel switching).

5. The Victorian Government's Greenhouse Policy Framework

AGL supports the key elements of Victoria's Greenhouse Policy Framework: a long-term greenhouse gas emission target supported by an emissions trading scheme; and the Victorian Renewable Energy Target to drive deployment of zero emission technologies. AGL is not convinced that additional policy measures are required to reduce greenhouse gas emissions in Victoria.

A well designed emissions trading scheme will deliver abatement prescribed by the emissions target being pursued. The associated pricing of emissions is likely to lead to higher energy prices that internalise greenhouse externalities. This will enhance the viability of energy conservation measures. Energy conservation policies established to address greenhouse gas emissions direct resources towards energy conservation irrespective of whether there are more economic methods of reducing emissions (e.g. renewable energy, fuel switching, hybrid vehicles). As such, AGL believes that emissions trading, rather than energy conservation policies, should be used to reduce greenhouse gas emissions.

² <http://www.pc.gov.au/inquiry/energy/finalreport/energy.pdf>

However, AGL does support the introduction of policies that are designed to overcome the barriers to energy efficiency outlined in previous sections.

6. The Victorian Energy Efficiency Target Scheme

AGL does not support the introduction of the Victorian Energy Efficiency Target Scheme in its current form. The key failings of this policy are:

- Arbitrary Target: It is almost impossible to determine an appropriate target. By definition, energy efficiency refers to the efficient use of energy. A more appropriate policy package would seek to overcome the institutional barriers allowing all cost-effective measures to be deployed.
- Compliance Costs: Retailers in Australia are already required to comply with the following measures: NSW Greenhouse Gas Abatement Scheme, Victorian Renewable Energy Target, Mandatory Renewable Energy Target, NSW Renewable Energy Target and QLD 13% Gas Scheme. In addition, over the next few years, it is highly likely that retailers will be required to meet compliance obligations under a national emissions trading scheme for gas sales emissions. There is an inappropriate administrative burden being placed on electricity retailers which is adding to the costs of energy and thereby disadvantaging Australian industry.
- Verifiability: Many of the measures households could undertake to reduce energy consumption would be very difficult and costly to verify. The administrative costs of verifying energy reductions (e.g. ensuring that energy efficiency lighting is installed) at each household could outweigh the benefits achieved.

AGL agrees with the evaluation criteria outlined in the Issues Paper for the design of an energy efficiency policy: effectiveness; efficiency; simplicity; and flexibility. In its current form, the Victorian Energy Efficiency Target Scheme is not the most appropriate policy for deploying energy efficiency as it does not meet any of these criteria. It is important to note that the Productivity Commission³ recommended that energy efficiency targets and schemes not be introduced because they fail to meet the criteria outlined in the Issues Paper:

- Effectiveness: It is difficult to determine whether the policy will actually achieve the reductions being sought. The difficulty in verifying reductions is likely to result in some level of 'deeming' being used which undermines the effectiveness of the policy. Market based policies such as trading are more suited to issues that are characterised by easily obtained accurate data (e.g. power station emissions in an emissions trading scheme).
- Efficiency: The policy is likely to result in significant administration and transaction costs. Each retailer will be required to devote significant resources to complying with the obligation established through the policy. The creation of each certificate will also result in significant verification costs.
- Simplicity: There are far simpler policies which could be deployed to reduce energy consumption. Regulation applied through appliance and other standards is a more appropriate policy response. The recent decision to phase out incandescent light globes is a good example of a simple cost effective policy designed to reduce energy consumption.
- Flexibility: The policy provides very little flexibility. Retailers are required to comply with the policy irrespective of the cost effectiveness of reducing energy consumption-related emissions relative to other sectors of the economy.

³ <http://www.pc.gov.au/inquiry/energy/finalreport/energy.pdf>

There are a range of energy efficiency policies which meet the criteria outlined in the Issues Paper. These include: appliance standards, regulation (e.g. phasing out of incandescent light globes) and funding of individual energy saving measures. Each of these policies is simple, efficient (modelled benefits are greater than costs) and effective.

In particular, AGL believes the Victorian Government should consider the Energy Savings Fund model developed in NSW. This policy measure requires distribution network providers to contribute to a central Energy Savings Fund.⁴ The Minister, after receiving advice from an expert independent panel, then allocates funds to project applicants based upon the projected energy savings. This policy would achieve the exact same outcome as an energy efficiency trading scheme but would not involve significant transaction costs.

7. Key Design Features: The Target and Timeframe

As outlined above, AGL does not support the introduction of a Victorian Energy Efficiency Target Scheme in its current form. However, if the policy is to be implemented, AGL believes that compliance obligations should not be imposed until at least 2008. It is crucial that the rules underpinning the operation the scheme are known well before this date. If adequate notice of the rules is not given, there is likely to be significantly more price volatility early in the life of the scheme.

AGL believes that target should be set after careful consideration of the economics of energy efficiency across households in Victoria. If the target adopted resulted in reductions in consumption beyond an efficient level, utility would be constrained. If the target resulted in smaller reductions than necessary to achieve economic efficiency, the transaction costs of the scheme may end up outweighing the economic benefits realised. AGL believes that the target adopted should be supported by detailed economic modelling.

AGL does not support broadening coverage of the scheme after it commences (unless coverage timetables are known before the scheme commences). As the price of permits will be determined by the overall target and the cost of options available, adjusting the target and coverage after the scheme commences is likely to significantly alter long-term prices and lead to increased price volatility.

8. Key Design Features: Relevant Entities

AGL believes that distribution network providers are better placed to be relevant entities under the scheme. Each retailer's sales will increase and decrease in each compliance period based upon customer churn. This uncertainty about sales and energy consumption makes verification and measurement significantly difficult for retailers.

Each distributor has a stable customer base, which is based upon geographic location. This stability would provide for easier verification and measurement. Each year, the distributors sales in MWh could be accurately measured and then compared with the previous compliance period.

9. Key Design Features: Banking and Borrowing

If it proceeds in its current form, AGL supports the inclusion of banking and borrowing in the proposed Victorian Energy Efficiency Target Scheme. Banking adds to the environmental effectiveness of the scheme (by allowing early energy efficiency savings to be recognised in later periods). AGL believes that market participants are unlikely to bank certificates for long periods of time. This is because there is an opportunity cost associated with holding certificates (i.e. if they were sold, the money obtained could be used to earn interest). The inclusion of limited borrowing would ensure that liable parties are not penalised for relatively small mistakes made during the course of the scheme that have no bearing on its environmental effectiveness.

⁴ The network providers recoup these contributions through a distribution network levy paid by customers.

10. Key Design Features: Penalty

The Issues Paper states that a penalty for non-compliance (i.e. not holding the required level of certificates) should be set at a level that caps the cost of the scheme at an acceptable level but also encourages compliance. AGL supports this approach. The penalty should be set just above the estimated marginal cost of compliance (determined by economic modelling). By setting the penalty at this level and adjusting the penalty over time to account for inflation, there is no financial incentive for industry to avoid purchasing the required level of certificates. However, if the modelling has significantly underestimated the cost of compliance, the penalty will act to cap the cost of the scheme. This will provide business with investment certainty.

If a business fails to meet its obligations, the penalty paid should be used by government to purchase additional energy savings. This would remove the need for a 'make good' provision. If penalty payments are assigned to an energy savings fund, AGL does not believe that there is any justification for inclusion of a make good provision.

11. Conclusion

In conclusion, AGL believes that the Victorian Energy Efficiency Target Scheme should not be implemented but the following measures should be considered to cost-effectively promote the efficient use of energy:

- The implementation of a distribution network provider focused policy based upon the Energy Savings Fund model used in NSW.
- A transition to cost-reflective pricing with a view to removing price regulation at the end of the current price paths. To ensure customers in genuine hardship are adequately protected, Governments should provide direct and transparent payments to customers experiencing genuine hardship.
- The continued development and deployment of minimum performance standards for appliances and the built environment that provide energy efficiency gains where they are cost effective over the lifetime of the product.