24 July 2009

The Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Mr Hawkins

Inquiry into: Renewable Energy Bills

Thank you for the opportunity to provide a submission to the Economics Legislation Committee's inquiry into Renewable Energy (Electricity) Amendment Bill 2009 and a related bill.

The Energy Users Association of Australia has a strong interest in this proposed legislation, which will have important impacts on our members, including higher energy prices. We have set out these issues in the attachment.

We would be pleased to discuss the contents of this submission with the Committee in due course.

Yours sincerely

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Energy Users Association of Australia submission to Economics Legislation Committee inquiry into the Renewable Energy Bills

24 July 2009

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Summary

The main points in our submission are as follows:

1. **The RET is expensive and will not meet its target:** Analysis by Access Economics suggests that the RET will cost around $45bn over the next 21 years, will raise electricity prices by $12/MWh (this is around 26% of the wholesale cost of power and more than the cost of electricity transmission) by 2020 and despite this, the Government's renewable electricity target will not be met.
2. **The Federal and State governments, not energy users, should pay for the pecuniary benefits associated with the development of the renewable energy sector:** The RET will provide payroll tax income to State governments and income taxes to the Commonwealth. The Federal and State governments should take account of the pecuniary benefits it will receive from the renewable energy sector, in funding some of the subsidy needed to support this sector, rather than placing the full burden of the subsidy onto energy users.
3. **The RET should be a broad-based energy sector emission reduction policy that is complementary to the CPRS, rather than a renewable electricity generation policy**: This means that the definition of REC-eligible technologies should include all renewable thermal technologies and energy efficiency opportunities. In addition, the allocation of multiple RECs to specific technologies should be abandoned.
4. **The fundamental RET design should be re-considered:** The RET exposes renewables developers to substantial levels of sovereign risk and provides a competitive advantage to incumbent retailers, which will undermine the competitiveness of the wholesale electricity market and impede new entry into renewable energy.
5. **The REC-exemption arrangements need to be re-considered:** The proposed arrangements will create a significant electricity price differential between exempt and non-exempt users. Whilst there is a rationale for such exemptions given that a large target imposes higher costs and trade exposed industries will loose competitiveness, the Government has not addressed all the issues and we are not convinced that the Government has got the balance right. The fact that the Government has not released any modelling of the proportionately greater impacts of the scheme on non-exempt electricity consumers is also a cause for concern.

Introduction

This submission describes the Energy Users Association of Australia's (EUAA) concerns with the proposed legislation on renewable energy. The submission reiterates some points that we have previously made in submissions to the Government on the Exposure Draft legislation and the Government's first consultation paper. It also introduces new analysis and information including the results of analysis that the EUAA commissioned from Access Economics to model the impact of the Renewable Energy Target (RET) on electricity users. After describing this, the submission then sets out our concerns that:

- It is not clear whether the RET is meant to be a complementary emission abatement scheme or an industry development scheme;
- Government should pay for the pecuniary benefits associated with the RET scheme;
- The fundamental design of the RET should be re-considered; and
- Exemption arrangements should be further considered.

The EUAA supports greater use of renewable energy provided that this is economically justified or that industry development of renewable technology that is sub-economic is based on sound policies which do not force energy users to fund such development. The funding of such development is essentially a policy choice by the Government and should be funded accordingly.

The EUAA is the national association of energy users (electricity and has) and has over 100 members, including many of Australia's largest energy users. EUAA members operate in many sectors of the economy, use a significant amount of energy, and make a major contribution to the economy through provision of goods and services, trade, investment and jobs.

The RET will have a significant impact on electricity users

The expanded RET is known to have significant impacts on electricity users, especially by increasing the costs they pay for their electricity as the target is expanded over time. The EUAA has therefore commissioned Access Economics to model the impact of the expanded Renewable Energy Target (RET) and the Carbon Pollution Reduction Scheme (CPRS) on energy users. We intend to publish their report once it is completed. The results of their analysis to date are cause for concern to energy users. In particular, Access Economics has concluded that:

- The RET target will not be met. By 2030, they expect that after accounting for Green Power demand, the total supply of RECs will be 14% or 8,000,000 certificates short of the target. By implication, the Government will earn total penalty income (effectively paid by energy users through their retailers for failing to surrender RECs) of around $608m from the scheme. This means that the Government will be deriving additional income from energy users, through the scheme but not delivering the full complement of renewable energy.
- REC prices will hit $76 by 2020, their tax-effective penalty level.
- The RET will cause average energy costs to rise by $12/MWh by 2020. This is around 26% of the average wholesale electricity price between 2004 and 2008. Alternatively, it is around the average cost of transmitting electricity in the National Electricity Market.
- The proposed exemption arrangements mean that impacts on end users will differ considerably. For non-EITE (Emission Intensive Trade Exposed) exempt sectors the increase will be $15.5/MWh, for 66% EITE-exempt energy users the increase will be $4/MWh, while for 94.5% EITE-exempt energy users, the increase will be $0.7/MWh.

- The effective cost of emission abatement under the RET will be $105/tCO2e (under the Government's CPRS-5 scenario) rising to $115/tCO2e (under the Government's CPRS-25 scenario). The cost of this abatement is roughly twice the cost of abatement under the CPRS.

In addition to the direct costs of the RET policy, there are likely to be significant indirect costs, such as for the augmentation of the transmission system, and development of additional (fossil fuel) peaking capacity to compensate for the local and aggregate impact of intermittency of renewable generation. In the Australian Energy Market Commission's current proposals, it is energy users rather than renewable developers that will be bearing much of these additional costs.

These results should be of considerable concern. The fact that the RET will deliver emission reductions at such high cost, and that ultimately REC supply will fail to meet REC demand, is particularly worrying.

It is not clear whether the RET is an emission abatement or industry development policy

It is not clear whether the RET is primarily an emission abatement or industry development policy. It has some characteristics of the former. For example, the legislation to implement it is linked to the CPRS, and exemptions from REC liabilities are linked to the exemption from CPRS liability.

On the other hand, the RET has many characteristics of an industry development policy. The Mandatory Renewable Energy Target (MRET) started as an industry development subsidy scheme in 2001, and the Government's White Paper on the Carbon Pollution Reduction Scheme describes the RET as a "*transitional measure that will support the development of a domestic renewable power industry and prepare the electricity sector for its contribution to the significant emissions reductions needed to tackle climate change*".

Whether the RET is primarily an emission abatement or industry development policy might be dismissed as a semantic distinction. But, we believe it is a very significant issue:

- If it is a complementary emission abatement policy then it should include all energy-related abatement opportunities so that funds are directed to the cheapest possible sources of abatement. This would mean including other renewable energy applications in the RET beyond water heating. It would also be appropriate to include energy efficiency within the scheme.
- On the other hand, if it is a renewable electricity generation industry policy, then it should not include renewable thermal technologies or energy efficiency, but should instead to be restricted to the (relatively higher cost) renewable electricity generation technologies.

We suggest that the Government's failure to clarify the priorities for the RET means that it is neither providing the lowest cost abatement in the energy sector (because it excludes energy efficiency and several low cost renewable thermal energy technologies); nor is it achieving effective industry development (because renewable electricity generation is being crowded-out by solar water heaters and heat pumps).

We recommend that the RET should be, primarily, a complementary emission abatement policy for the Australian energy sector, rather than a renewable electricity industry development policy. This means:

- *Broadening the scheme as widely as possible to include as many energy efficiency and energy sector abatement opportunities as possible;*
- *Withdrawing preferential arrangements for specific technologies. For example, the REC multiplier for small generating technologies is not consistent with the promotion of least cost abatement.*

Government should pay for the pecuniary benefits associated with the development of the renewables industry

The modelling by Access Economics implies that the total subsidy to be paid by energy users over the period from 2010 to 2030 is $45bn. It is helpful to be clear on the source and application of these funds. Under the proposed legislation, the great bulk of this will be collected from electricity users that have no REC exemption. This is the vast majority of electricity users by number, but which together account for around 70% of electricity consumption.

At present, the main recipient of REC income is solar water heater and heat pump suppliers. These technologies accounted for around 40% of RECs created in 2008, and will probably account for around 60%, or more, of RECs created in 2009. Continued growth in RECs from these technologies will see them playing a significant, if not dominant, role in the supply of RECs in the period to 2020.

We recognise that energy users will gain some benefit from renewable subsidies, by reducing the emission intensity of electricity production and hence decreasing sensitivity to higher emission prices. However, there are other claimed benefits from the REC subsidies which will confer costs on energy users. State Governments will benefit from this directly through payroll taxes, and through enhanced economic activity. The Federal Government will gain additional income tax from the profits of the new market participants. Assisting the development of specific industries is the Government's prerogative. Government supports industry development in manufacturing and defence, and funds this development. We suggest that the same argument should apply to the additional cost of developing the renewable electricity sector.

In our submissions to the Government in its earlier consultation on aspects of the RET legislation, we raised this issue but the proposed legislation has moved in the opposite direction – by increasing the targets after 2020 and through the small generating unit multiplier.

The legislation should be amended so that the Government, not energy users, fund the pecuniary benefits that the RET will deliver.

The fundamental design of the RET should be re-considered

In our earlier submissions to the Government, we made clear our concern about the absence of detailed analysis on the design of the most appropriate subsidy mechanisms. This is of particular concern in view of the fact that the RET is estimated to cost $45bn over the next 21 years. Getting it right clearly matters.

We have two main concerns with the use of a tradeable quota as the subsidy mechanism. The first is that it exposes renewable developers to high levels of sovereign risk and this will be reflected in higher discount rates and hence more expensive investment – which energy users are paying for. The second is that the RET provides a competitive advantage to incumbent retailers and this undermines the competitiveness of the electricity sector.

The RET concentrates sovereign risk

Investors in renewable electricity plant face considerable uncertainty on the future price of RECs. Investors will reflect this in higher discount rates. Through its decisions on the design and implementation of the RET, Government can significantly influence the REC price. In the recent past there have been some significant changes including the possible development of a number of State-based quota schemes, the inclusion of gas-boosted solar water heaters in MRET, and significant changes in State and Federal government capital subsidies for SWH. The proposed legislation will introduce further significant changes including the expanded target, small generating unit multiplier, and REC exemptions for some electricity consumers. The Government has also proposed five-yearly reviews, which have the prospect of changes that could significantly affect future supply and demand, and hence REC prices. Such reviews have value in providing an opportunity for assessment and adjustment and are therefore supported, but inevitably also result in additional uncertainty. A change

in Government could result in further significant changes to scheme design. The uncertainty about changes in the design of the scheme, and related subsidies is likely to be reflected in a higher cost of capital (and hence more expensive subsidies) than it would otherwise need to be to.

Alternative approaches to quota schemes exist, and these alternative approaches are predominantly used for the subsidy of renewable electricity in other countries. Specifically, price-based subsidy schemes such as feed-in tariffs offer the prospect of greater income certainty and hence facilitate lower investment costs. Up-front capital grants also reduce investment risks associated with renewable electricity plants. Such price-based subsidy mechanisms may therefore reduce investment risks attributable to changeable government decisions, and thereby reduce the level of subsidy needed to secure a specified increment of renewable generation.

Whilst the EUAA has raised these matters in its previous submissions on the expanded RET, they have not formed part of the more general debate and discussion about the development of a 20 per cent RET. Instead, there has been an implicit assumption - since this policy was first announced - that an MRET type quota scheme would be used as the exclusive means of delivering this target, even though the distortions and high costs of such schemes are well known. The lack of attention to this important matter is a significant concern to the EUAA.

Price versus quantity subsidy mechanisms have been the subject of extensive debate in other countries. The same issue should be considered in Australian in deciding on the most effective mechanism. This decision should also be informed by identifying the reasons a quantity-based mechanism is preferred. The large cross subsidy - estimated by Access Economics at some $45 billion - makes this even more important. In particular, if a quantity mechanism is preferred due to its ability to provide abatement certainty (which is one of the reasons cap-and-trade schemes are favoured over carbon taxes), then this lends additional weight to the expanded RET being an additional abatement policy rather than industry development policy and our recommendations to expand any scheme to include lower cost abatement opportunities take on additional weight.

The RET is likely to detrimentally affect the competitiveness of the electricity market

The RET places a mandatory requirement for electricity retailers (and major energy users who purchase electricity directly from the wholesale market) to procure a number of REC's each year, in proportion to the electricity they supply (or purchase).

However, retail supply in the National Electricity Market is highly concentrated with a handful of retailers, who are vertically integrated such that they own or control a significant amount of generation to meet their end-customer demands.

The implication of this concentration is that these retailers have a very strong position in negotiations for the purchase of renewable electricity. Through their electricity customer relationships, they also have a competitive advantage in the management of the uncertainty of REC prices. Specifically, retailers have an obligation to procure RECs on behalf of their customers and owning the plant they use to deliver the REC means that they have a "natural" hedge against REC price rises. This provides a competitive advantage to these retailers in the development of renewable capacity and is likely to mean that investment in renewable electricity generation will be dominated by the vertically integrated retailers.

This will have implications for the distribution of the profits from renewable electricity production (more going to the retailers than the renewable generators) and therefore the entry of independent renewable power producers. This is likely to have a detrimental impact on the competitiveness of the renewable electricity sector and the development of a renewable industry (one of the stated objectives of the scheme).

This issue is significant not least because there are alternative approaches that should be examined to assess how they compare, namely, feed-in tariffs or similar price-based subsidy mechanisms – that

can be adopted to provide greater opportunity for independent power producers, and thereby promote supply-side competition. This issue should be considered further.

Exemption arrangements should be re-considered

Whether or not some end users should be exempt from REC obligations is a complex question. Strong arguments can be made on equity and efficiency grounds both for and against exemption. The EUAA understands the reasons why those industries most at risk from the high costs imposed by the RET would seek exemptions from it.

The fact that exemptions are provided under the CPRS for EITE activities exposed to carbon leakage risks, makes the likelihood of similar exemptions from the RET more likely. The size of the target increases its costs to industry and this makes the argument for exemptions more persuasive. However, as shown above, granting exemptions has the effect of increasing the burden imposed on remaining consumers. Moreover, the approach to determining exemptions will always be problematic. Some non-exempt activities or industries will suffer severe commercial damage in view of the higher burden they are required to bear. This could apply particularly to trade exposed sectors that do not qualify for EITE exemption but are still highly vulnerable to increases in their electricity costs compared to their international competitors. The EUAA is aware of such industries.

As previously mentioned, the modelling by Access Economics has, however, shown that the impact of the Government's proposed exemptions are that for consumers that have no exemption, average prices will rise by $15/MWh by 2020, while for 66% EITE-exempt energy users the increase will be $4/MWh, and for 94.5% EITE-exempt energy users the increase will be $0.7/MWh. These are clearly very stark differences and illustrate the extent to which exemptions have the effect of increasing the costs of the scheme to non-exempt industries.

The higher price rises for non-exempt users come on top of significant expected rises attributable to the CPRS, some very large price rises for electricity transmission and distribution either now being implemented or in prospect, a failure to follow through with energy reform and diminished competition in energy since the reforms of the 1990s.

The Government's approach to exemption is to treat price rises attributable to the RET in the same way as price rises attributable to the CPRS. This would be consistent with the definition of the RET as a complementary emission abatement policy. As we have discussed earlier, whether the RET is an industry development policy or an emission abatement policy is not clear. If it is an industry development policy – as the Government effectively says it is – then the placing the entire burden of the subsidy on electricity users is dubious. That burden is magnified, as are its potential negative impacts, when it falls on a sub-set of users, some of whom are trade exposed.

Exemptions – to the extent that any are appropriate – need to take account of the evidence of the impact of those exemptions on the beneficiaries and the payees. It also needs to take account of the fundamental rationale for the RET scheme, and deeper considerations of fairness and efficiency in exempting some classes of electricity users from some obligations but not others. We are concerned that the Government's proposals have not addressed these issues and have not yet got the policy or balance right. The fact that the Government has not released any modelling of the proportionately greater impacts of the scheme on non-exempt areas is also a cause for concern.