Independent Pricing and Regulatory Tribunal

IPART
New South Wales

PO Box K35, Haymarket Post Shop NSW 1240
Level 15, 2-24 Rawson Place, Sydney NSW 2000
T (02) 9290 8400 F (02) 9290 2061
ABN 49 202 260 878

www.ipart.nsw.gov.au

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Mark Paterson
NSW Trade & Investment
Level 47, MLC Centre
19 Martin Place
SYDNEY NSW 2000

Contact Anna Brakey
T (02) 9290 8438
E anna_brakey@ipart.nsw.gov.au

Dear Mr Paterson, Mark

IPART SUBMISSION TO REVIEW OF THE NSW ENERGY SAVINGS SCHEME

Thank you for the opportunity to comment on the Review of the NSW Energy Savings Scheme. We support a thorough review of the scheme.

The Independent Pricing and Regulatory Tribunal (IPART) is the Scheme Administrator and Regulator of the NSW Energy Saving Scheme (ESS). We also monitor retail electricity prices and regulate retail gas prices. Our experience makes us well-placed to comment on the Review of the NSW Energy Savings Scheme and its impact on energy prices.

Our comments are guided by our objective of maximising the efficiency of the scheme's design. We support using a market-based, tradable certificate scheme as a means to achieve the Government's energy savings target in the most efficient manner. We expect such an approach will ameliorate the burden of higher energy prices on households.

We do not support the proposal in the Options Paper to *expand* our responsibilities to include a role in assisting potential participants to become involved in the scheme and to assist them to comply with the scheme. This would create risks with regards to our ability to be the independent administrator of the scheme. Promoting the scheme should be undertaken separately from independent administration and regulation.

We support the proposal to enhance the enforcement options available to the Scheme Administrator. In particular, we recommend that the Scheme Administrator be given greater options to address any improper creation of ESCs by accredited certificate providers.

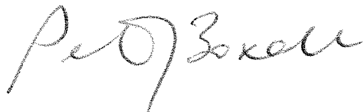
After considering the proposed options set out in the Options paper, we recommend that:

- the electricity target be retained at its current level of 5%
- gas should not be included in the scheme until sufficient analysis has been undertaken to set an appropriate target

- gas retailers face their own liability rather than the electricity target being increased to account for gas
- the penalty be retained at its current level
- the scheme be extended to 2025, subject to a review of the complementarity between the national Emissions Reduction Fund (ERF) and the ESS

Given the detail of the review and our role in the scheme, we would welcome the opportunity to discuss our submission further with your staff. The staff contacts in IPART are Anna Brakey on 9290 8438 and Rob McKenna on 9113 7782.

Yours sincerely



Peter J. Boxall AO
Chairman

Independent Pricing and Regulatory Tribunal

Submission to review of the NSW Energy Savings Scheme

May 2015

Inquiries regarding this document should be directed to a staff member:

Anna Brakey	(02) 9290 8438
Rob McKenna	(02) 9113 7782

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1 Overview

Thank you for the opportunity to comment on the Review of the NSW Energy Savings Scheme. We support a thorough review of the scheme.

Independent Pricing and Regulatory Tribunal (IPART) is the Scheme Administrator and Regulator of the NSW Energy Saving Scheme (ESS). We also monitor retail electricity prices and regulate retail gas prices. Our experience makes us well-placed to comment on the Review of the NSW Energy Savings Scheme and its impact on energy prices.

Our comments are guided by our objective of maximising the efficiency of the scheme's design. Our practical experience as the current scheme administrator and regulator allows us to offer refinements to the proposed approach. We support using a market-based, tradable certificate scheme as a means to achieve the Government's energy savings target in the most efficient manner. We expect such an approach will ameliorate the burden of higher energy prices on households.

We do not agree with the proposal in the Options Paper to *expand* our responsibilities to include a role in assisting potential participants to become involved in the scheme and to assist them to comply with the scheme. This would create risks with regards to our ability to be the independent administrator of the scheme. Promoting the scheme should be undertaken separately from independent administration and regulation.

We support the proposal to enhance the enforcement options available to the Scheme Administrator. In particular, we recommend that the Scheme Administrator be given greater options available to it to address any improper creation of ESCs by accredited certificate providers; for instance by allowing the Scheme Administrator:

- to issue penalty notices (following one or more official warning notices); and
- to require an undertaking, at the time of application for accreditation, under which an applicant (if accredited) agrees to set aside a certain number of ESCs and to surrender 'set aside' ESCs in the event of a poor audit result.

We consider that a failure to comply with such an undertaking should be a ground for cancellation or suspension of accreditation.

Further, we consider that the report underestimates the cost of administration and compliance with respect to the scheme. This has the effect of overstating the benefit to cost ratios.

We note that the Options Paper proposes a range of changes to the scheme settings. After considering the proposed options[1], we recommend that:

- **The electricity target be retained at its current level of 5% because:**
  - the analysis that underpins the recommended increase to 6.5% overstates the benefits. In particular the paper appears to assume that all displaced generation is from black coal fired generation, yielding health benefits of $14/MWh; this is not a reasonable assumption.
  - further, by increasing the target from 5.0 to 6.5% the benefit-cost ratio deteriorates significantly from 5.1 to 2.7 while there is only a marginal increase in net present value.
- **Gas should not be included in the scheme until sufficient analysis has been undertaken to set an appropriate target.** There is insufficient justification to support a gas target of 6.5% for gas retailers (or to add an additional 1.5% to the electricity target to include gas if the schemes are combined). The evidence presented suggests that there is a higher net benefit in having a lower gas target, but a lower target appears not to have been investigated.
- **Gas retailers should face their own liability rather than the electricity target being increased to account for gas**. The potential inefficiency introduced by cross-subsidisation could be much higher than the 0.1% or $1 million net benefit estimated in the review.
- **The penalty be retained at its current level until further analysis is undertaken, including modelling a lower penalty rate**. The analysis examined only retaining or increasing the current penalty. We consider that a lower penalty could yield greater benefits. Further, the analysis that was presented does not support an increase in the penalty.
- **The scheme be extended to 2025, subject to undertaking a review of complementarity between the national Emissions Reduction Fund (ERF) and the ESS. IPART would be well placed to undertake such a review.**

Our recommendations differ therefore from some of the recommendations put forward in the Options Paper. In our view, the analysis presented in the Options Paper does not adequately support the recommendations and we therefore recommend further analysis and consideration.

[1] NSW Government, *Review of the NSW Energy Savings Scheme – Part 2: Options Paper*, April 2015.

2 Scheme administration

We do not support the proposal set out in the Options Paper to expand our responsibilities to include a role in assisting potential participants to become involved in the scheme and to assist them to comply with the scheme. This would create risks with regards to our ability to be the independent administrator of the scheme. Promoting the scheme should be undertaken separately from independent administration and regulation.

We provide information and education to potential participants and accredited parties on the requirements of the scheme and our approach to regulation. We see this as part of our role as an effective regulator and administrator. We believe this is distinct from a role assisting potential participants to become accredited or assisting them to comply once participating in the scheme.

We consider that the report underestimates the efficient cost of administration and compliance with respect to the scheme. This has the effect of overstating the benefit to cost ratios.

The compliance costs used in the analysis were sourced from 2012 survey data. However, in 2014 the ESS Rule amendments greatly increased the complexity of the scheme, increasing the cost of efficient administration. Further, the inclusion of gas in the scheme will further increase the complexity and costs of administering the scheme. Therefore, the compliance costs sourced from a 2012 survey would underestimate the costs of the scheme.

The report notes concerns about the efficiency and transparency of our administration. We are committed to being accountable for our performance but we consider that the proposed additional reporting requirements are not an effective means of addressing the concerns raised about efficiency and transparency. Over the past year we have increased transparency by publishing comprehensive guidance material and increasing the number of feedback channels, while concurrently reducing processing times through improved processes and more efficient systems.

We would recommend to the Government to ensure the ESS Rule is efficient and to minimise red tape by removing unnecessary complexity. This would improve scheme administration and reduce costs while maintaining the integrity of the scheme.

We support the proposal to enhance the enforcement options available to the Scheme Administrator. In particular, we consider that the Scheme Administrator should have greater options available to address any improper creation of ESCs by accredited certificate providers. Our current enforcement options under the Act include:

- cancellation/suspension of an accredited certificate provider's accreditation; and

- an order requiring the surrender of ESCs, following successful a criminal prosecution.

These options are not appropriate for addressing minor instances of non-compliance. There should be options available to address instances of non-compliance in an expeditious and inexpensive manner. To this end, we support the proposals in the Options Paper to allow the Scheme Administrator:

- to issue penalty notices (following one or more official warning notices); and
- to require an undertaking, at the time of application for accreditation, under which an applicant (if accredited) agrees to set aside a certain number of ESCs and to surrender 'set aside' ESCs in the event of a poor audit result.

We consider that a failure to comply with such an undertaking should be a ground for cancellation or suspension of accreditation.

Other licensing regimes have a broader range of enforcement options, such as imposing monetary penalties and requiring a licensee to take specified action (see, for instance, the licensing enforcement options available under the *Water Industry Competition Act 2006)*.

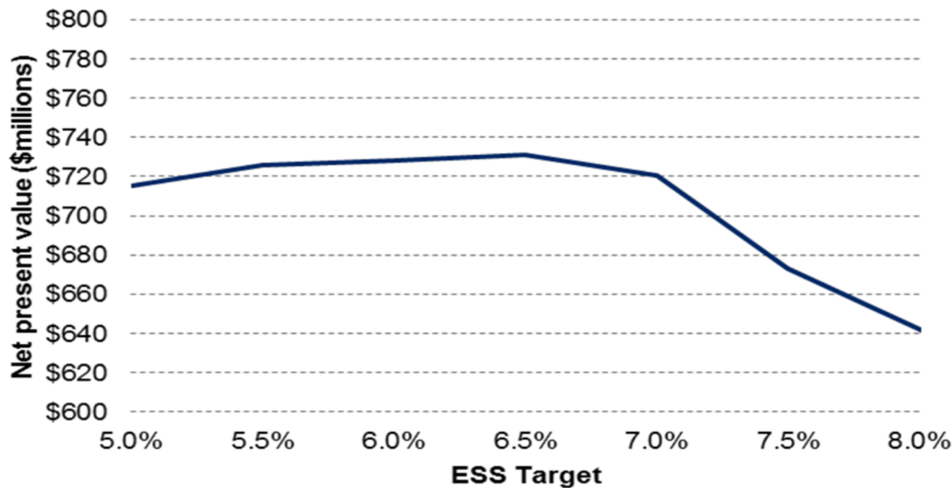
3 Our comments on the proposed options

3.1 Electricity target

1. We recommend that the target be retained at its current level of 5% because
   - the analysis that underpins the recommended increase to 6.5% overstates the benefits. For example the assumption that all displaced generation is from black coal fired generation, yielding health benefits of $14/MWh; is not a reasonable assumption.
   - by increasing the target from 5.0 to 6.5% the benefit-cost ratio deteriorates significantly from 5.1 to 2.7 while there is only a marginal increase in net present value.

We do not support the recommended option to increase the target from 5.0% to 6.5%. The review bases its recommendation for a 6.5% target on the fact that the net present value of the scheme reaches its maximum value with that target (see Figure 3, reproduced below).

Figure 3 from the Options Paper Net economic benefit of ESS target



Source: Options Paper, p 20.

The health benefits are based on two simplifying assumptions that require further consideration:

- The first assumption, upon which the health cost rate over time (see figure 28, page 133) is founded, is that all NSW generation is based on black coal. However, figure 6 (page 39) demonstrates that there is substantial hydro, OCGT and CCGT generating capacity in NSW. These other generation technologies would lead to substantially lower health costs than the $14.40/MWh in 2016 used in the analysis and derived from coal plant operations (see footnote 58, page. 29).
- The second assumption is that as Hunter Valley population densities are roughly 20% of median European population densities, the high health cost rates observed in Europe would apply in NSW with the 20% scaling factor (see table 28). That approach to estimating the influential health externalities lacks a proper empirical grounding in the NSW situation.

It is clear that for target values above 7% the net present value of the ESS scheme declines sharply. The precautionary principle indicates that the target should be set away from that range.

The review suggests that increasing the target will lessen the oversupply of permits.[2] The oversupply of permits was observed in 2012 and 2013 when the target was 3.5% and 4.5% respectively. This is lower than the current target of 5.0%. Figure 1 suggests that the price mechanism is working to resolve the

2 NSW Government , *Review of the NSW Energy Savings Scheme - Part 2: Options Paper,* April 2015, p 2.

oversupply. Further, the majority of certificates were generated from commercial lighting activity, which is scheduled to decline from 2016.[3]

An oversupply would usually result in lower certificate prices, which means that the scheme will achieve its objectives at lower cost. As this is a positive outcome - an oversupply of certificates should not be used to justify an increase the target.

3.2 Extending the scheme to gas and setting the gas target

2 IPART recommends that gas should not be included in the scheme until sufficient analysis has been undertaken to set a target and that a 6.5% target is not justified.

Extending coverage to gas

Until there is sufficient analysis to set an appropriate gas target, gas should not be included in the scheme. While the incremental net benefit of extending the scheme coverage to include gas appears material,[4] we consider that further analysis needs to be undertaken before a target for gas is set.

We do not consider there to be sufficient justification for a gas target of 6.5% for gas retailers, or to add an additional 1.5% to the electricity target to include gas. The evidence in the Options Paper suggests that a lower gas target would deliver a higher net benefit.

Further, the review has overstated the benefit of extending coverage to gas by wrongly comparing the incremental cost/benefit of extending coverage to gas. In addition to including gas[5], these results appear to compare a 6.5% electricity target against the 5% target (so the reported benefits also reflect the impact of increasing the electricity target)[6]. This overstates the benefit of extending the scheme to gas.

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3 Ibid., p 17.

4 According to Table 34 in the Options Paper, the incremental increase in NPV from including gas in the scheme (to 2020 only) is:

- $200 million for a separate gas scheme (Column 7: $931 million less column 3: $731 million)
- $275 million for a combined scheme (gas and electricity): (Column 8: $1007 million less column 3: $731 million).

5 Table 15 of the report.

6 For example, the $291 million net benefit reports in column 2 of Table 15 reflects the difference between the net benefit in column 8 of Table 34 less the net benefit in column 2 of Table 34 (less rounding). But, in addition to the change in gas target, column 8 reflects a 6.5% electricity target while Column 2 reflects a 5% electricity target. The correct comparison should be against column 3 of Table 34, which also reflects the 6.5% electricity target.

Liability for gas target

With regard to liability under a combined gas and electricity efficiency scheme, the report recommends that electricity retailers assume liability for the combined scheme, as opposed to introducing additional liability for gas retailers.

We consider the estimated benefit of this approach of $1 million, or 0.1% to be very low when compared to the resulting cross-subsidy potentially introduced under this arrangement as electricity consumers bear the full cost while gas consumers realise the gains from gas efficiency. We not also that the comparison of these options is only presented to 2020, not to 2025.

3.3 Penalty

IPART recommends that the penalty be retained at its current level (indexed to inflation) until further analysis is undertaken. This analysis should include a scenario that lowers the penalty, which could yield a higher net benefit.

We do not support with increasing the penalty because the analysis in the Options Paper does not support an increase. For instance, Table 8 shows that maintaining the penalty results in a higher net present value than setting penalties to reflect the avoidable short term costs of electricity supply ($562 million versus $487 million). Therefore the analysis does not appear to support an increase in the penalty – if certificate prices are higher than forecast, a higher penalty will result in lower net benefits.

3.4 Extending the scheme duration

3 IPART recommends that the scheme be extended to 2025, subject to a review of complementarity between the Emissions Reduction Fund (ERF) and the ESS.

We consider that the Options Paper demonstrates a case to extend the scheme to 2025. The incremental net present benefit of extending the scheme duration appears material.[7]

However, the scheme should operate and be extended only to the extent that it complements the Emissions Reduction Fund. Duplicative schemes or duplicative parts to the schemes potentially distort markets and result in inefficiencies. We recommend that the schemes be reviewed to test for complementarity. IPART is well placed to undertake such a review.

[7] Based on Table 34, the incremental increase in NPV from extending the scheme to 2025 is:
- $312 million for a 5.0% target (Column 5: $1027 million less column 2: $715 million).
- $367 million for a 6.5% target (Column 6: $1098 million less column 3: $731 million).