

27 April 2015

Mr James White
Assistant Secretary
Safeguard Mechanism Branch
Department of the Environment
51 Allara St
Canberra ACT 2000
via email: emissions-reduction-submissions@environment.gov.au

Dear Mr White

Department of the Environment
Emissions Reduction Fund: Safeguard mechanism
Submission to Consultation Paper – March 2015

The Energy Networks Association (ENA) welcomes the opportunity to make a submission to the Australian Government on the issue of the development of the Emissions Reduction Fund (ERF) Safeguard Mechanism.

The Energy Networks Association (ENA) is the national industry association representing the businesses operating Australia's electricity transmission and distribution and gas distribution networks. Member businesses provide energy to virtually every household and business in Australia. ENA members own and operate energy network infrastructure assets valued at over \$100 billion.

A number of ENA gas and electricity members have historically reported "Scope 1" emissions over 100,000 tonnes of CO₂e- under the *National Greenhouse and Energy Reporting Act 2007* (the NGER Act). Under the Government's proposed approach, it is understood that the relevant networks would be subject to the measures proposed under the ERF Safeguard Mechanism.

As noted in ENA's November 2013, February 2014 and May 2014 submissions, losses in gas networks and electricity are an inherent part of the operation of a network and there are already significant incentives to minimise such losses. The ability of networks to control emissions through current asset management programs is minimal.

The Australian Energy Regulator (AER) concluded in 2009 that it would not be appropriate to apply a new efficiency mechanism to distribution losses in the absence of ... *evidence that distribution losses are deviating from efficient levels.*¹

The Energy Efficiency Opportunities (EEO) program decided not to include gas or electricity networks after a series of trials by Sapere Research Group in July 2013 which found that:

¹ Page 17, Explanatory Statement to the Proposed Electricity Distribution Network Service Providers Efficiency Benefit Sharing Scheme, AER 2008.

...the opportunities to reduce fugitive emissions beyond the systematic replacement of mains the distributors are currently doing are immaterial.²

ENA's May 2014 submission on the design of the ERF noted the results of these trials which found that investments in reducing losses beyond a value that is economically efficient to attain would ultimately increase end user energy prices.

1. Conflicting treatment of networks

The NGER Act recognises that networks are dissimilar to other facilities types. Unlike other facilities that can be built as a separate entity to an existing facility, NGER Regulation 2.20 suggests that the provision of new services to customers, for example by extending a network, will be considered part of an *existing* network facility.

By contrast to the NGER Regulation, the proposed ERF Safeguard Mechanism appears to propose that networks will be treated as any other industrial facility. This becomes problematic when considering the development of rules around new investments.

Figure 1 of the ERF Safeguard Mechanism consultation paper outlines the decision pathway for applying baselines to new investments.

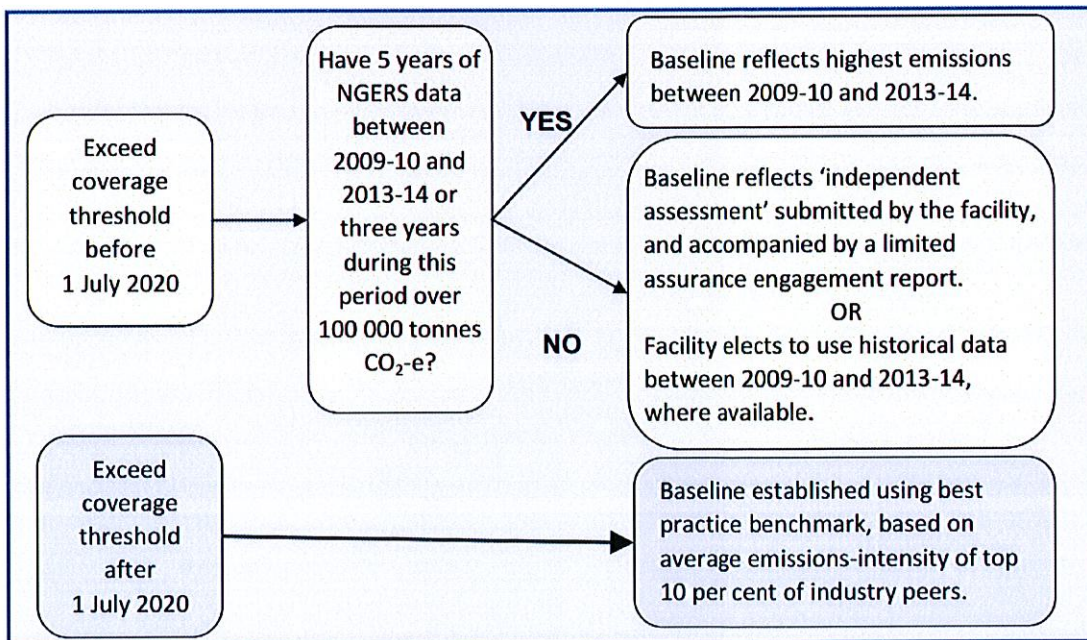


Figure 1 - possible arrangements for new investments (from the ERF Safeguard Mechanism consultation paper)

Figure 1 suggests that new investments in a facility with emissions that exceeds 100,000 tonnes of CO₂e- with 5 years of NGER data will be assigned a baseline based on the highest emissions between 2009-10 and 2013-14.

This effectively means that extending a network or adding new customers, which is not only normal business operation but a legal obligation in many circumstances, has the potential to increase a network's emissions above a baseline set using historic emissions profiles. The decision pathways in Figure 1 are not appropriate to accommodate the inherent features of efficient network utilisation, infill and extension. Consequently, a network could be subject to the Safeguard Mechanism compliance

enforcement process even though it is simply undertaking normal operations and meeting its legal obligations to connect customers.

2. Issues for Gas Networks

The Safeguards regime threshold is likely to capture a number of gas distribution networks. Gas distribution network service providers continually seek to minimise fugitive emissions as they are already subject to direct financial penalties in the form of having to 'make good' losses in the form of 'unaccounted for gas' in the distribution system.

Like electricity transmission and distribution network service providers, gas networks are subject to economic regulation of operating and capital efficiency, and are incentivised to undertake efficient network investments which include consideration of losses.

The efficient operation and extension of a gas network may result in an increase in the quantum of greenhouse gas emissions through network losses, for instance due to:

- extensions to the geographical extent of the gas network, which may be **beyond the control of the distribution business** (which has a regulatory obligation to connect new residential and commercial customers upon request); a commercial initiative or in response to government initiatives such as the Victorian Government's Energy for the Regions program.
- promotional activity **by a third party** (such as a retailer) that results in the addition of new connections on an existing network.

The ERF Safeguard Mechanism consultation paper suggests a number of options to "encourage compliance" could be enforced on gas networks even in circumstances where:

- the network service provider has no ability to limit the organic growth in emissions to the baseline level;
- the network service provider is already significantly incentivised to minimise fugitive emissions;
- increased gas network utilisation, infill or extension represents is generally positive to customer energy affordability and Australia's emissions intensity.

Some of the enforcement options contemplated may be impossible for networks to comply with, including requirements that facility emissions remain below their baselines. This effectively leaves the emissions safeguard regulator with two options in relation to networks whose normal business activities take their operations above an emissions baseline:

- a 'net emissions' approach which would require networks to increase costs to consumers in order to purchase carbon offsets; or
- the application of a civil penalty for non-compliance, with an amount to be specified in safeguard regulations.

These options need to be considered in the context of the regulatory framework which applies to gas networks, which are subject to independent economic regulation by the Australian Energy Regulator (AER). (The AER is currently completing a cycle of regulatory reviews for network service providers for a five year regulatory period). These agreements set the tariff a network operator is able to charge customers to recover efficient costs.

Under the proposed ERF Safeguard compliance processes, networks whose operations mean that they exceed baselines would either be required to purchase offsets or have a civil penalty applied. Either of these options would impose costs on the network operator.

In policy terms, the effect of such a mechanism would be equivalent to a tax – in that the energy network service provider is unable to limit the organic growth in emissions. If the net emissions approach is adopted and the cost of carbon offsets recognised by the regulator, the effect of the ERF safeguards mechanism is a tax on energy users. It increases the annual gas bill for customers without achieving a reduction in greenhouse gas emissions.

If the option of imposing a civil penalty is adopted, a regulated gas network may be unable to recover the costs as part of its regulated revenue, leaving the network operator to meet the costs. The effect of this option is an unavoidable tax on energy network service providers, which does not achieve a reduction in greenhouse gas emissions. It will however increase the regulatory risk of investors, which threatens to increase the cost of finance in a capital intensive industry; and so increase energy costs to Australian customers.

Institutional investors, debt markets and credit agencies routinely place great weight on factors of regulatory stability and predictability in investment assessments that affect the availability and terms of capital for Australian networks. Increased regulatory risk has the potential to increase the cost of capital for network businesses, and raise network charges for end consumers. The ENA is concerned that the current design of the ERF will add to uncertainty for investors around the application of baselines and penalties, leading to higher rates for lending due to increased risk resulting in higher network prices for consumers than would otherwise occur.

3. Options proposed under 'new investments' do not fit network operations

The proposed processes for 'new investments' in the consultation paper assume large, multi-year facility expansion projects with defined start and end dates. The consultation paper gives options for setting baselines of 'investments already underway' and another option allows for baselines to be set on investments without a final investment decision.

The ERF Safeguard Mechanism proposals around new investments do not adequately address a facility where the efficient operation results in expansion at a predictable and constant rate. Rather than one large multi-year process to add capability to a facility, as in the case in most industries likely to be covered, a network may be legally obliged to expand daily as new customers are connected. This incremental network growth is a substantial benefit to new and future network consumers as it results in a lower cost to serve individual network customers.

This form of continuous operation and expansion makes networks different from other industrial facility types featuring larger discrete expansions. The difference in operation was correctly recognised in the NGER reporting mechanism. ENA believes that the inherent differences of network facilities and their volume growth should continue to be recognised. An appropriate variation of the 'new investments' assessment could be developed under the ERF Safeguard Mechanism to accommodate standard network operations.

4. Alternative options for networks

The ENA has considered a number of options to achieve the Government's policy intent, while avoiding an unintentional tax on energy users which does not achieve emissions reduction:

One option for networks is that the baseline for a network could be defined in relative terms, as energy intensity, level rather than an absolute quantum of emissions. This would allow growth with each new connection being appropriately recognised as contributing to fugitive emissions. Such a system would allow a continually expanding, efficient and prudently operated, network to remain below the ERF safeguards baseline. The ENA recognises this would require the Safeguard Mechanism to depart from the stated preference for an absolute emissions baseline, in recognition of inherent differences in network facilities.

A potential alternative option is to define a Network-specific 'New Investment' mechanism. The mechanism could recognise a 'network facility' and that the normal operation of a network does not introduce sudden changes in emissions profile or type. In the Safeguard Mechanism consultation paper, the Government proposes that facilities that develop a new investment which results in 20% more emissions will be able to increase their baselines – however there is only one opportunity to set the baseline and it must be done using an accredited greenhouse gas auditor.

Gas networks large enough to produce 100,000 tonnes of CO₂e- generally have around 500,000 to 700,000 customer connections. For these networks, it is simply not possible to add the equivalent of 100,000 connections in a year due to the logistical effort and investment required to extend the network to this extent. It is also highly unlikely that networks will add this number over the expected lifetime of the ERF.

Networks will continue to grow over this period however and ENA suggest another option to allow for this growth. A potential option for setting baselines for facilities that undertake new investments is outlined in the consultation paper:

Baseline for each relevant output = Emissions intensity of production benchmark x production³

For gas networks with over 100,000 tonnes of emissions, an effective approach to setting baselines could be developed using known and documented rates of emissions intensity factors for gas, as listed in the NGER measurement determinations, and projections of customer connections.

The simplicity of defining the emissions intensity and 'product' suggests that there is also no requirement for verification by independent greenhouse gas auditors. A further option is to reset the baseline each year based on the actual increase in the size of the network length or increase in customer connections.

5. Issues for Electricity Networks

Generally speaking, electricity networks have very low levels of scope 1 emissions and therefore would not exceed the threshold for the safeguard regime of 100,000 tonnes CO₂e- per annum.

For the couple of network businesses who have supporting generation facilities these will be included as part of a broader electricity generation sector baseline. The connection between generators provided by the electricity network means that lower production by one generator must be met by generation elsewhere in the system. As a result, the Government is proposing that a single sector baseline covers all grid-connected electricity generation in the ERF Safeguard mechanism.

Networks with generation facilities will be included under the broader electricity generation sector baseline and may only be required to operate under an individual baseline if emissions from the whole sector move above the sector baseline. ENA believes this is an appropriate approach to developing baselines for electricity network facilities, on the assumption that individual baselines, if introduced, should focus on generation facilities of significant scale, which make a material contribution to the sector baseline.

³ Page 4, Ibid.

Executive Summary

The ENA does not support the application of baselines and penalties for gas or electrical network businesses under the Emissions Reduction Fund Safeguard mechanism. If the Government develops baselines and penalties that include networks, it should recognize:

- other than regulated programs of investment in improvements to energy network infrastructure, emissions from networks are in many cases beyond the control of the network operator;
- there is the potential for networks to exceed baselines in response to their legal obligation to connect customers, and as part of their normal operations increasing network utilisation;
- compliance measures such as civil penalties or obligations to secure carbon offsets would represent a tax on energy users without reducing greenhouse gas emissions; and
- as an alternative option to achieve the Government's policy intent, the inherent features of energy networks could be recognized in an emissions intensity measure; or in a Network-specific 'New Investment' mechanism.

The ENA welcomes the opportunity to participate in development of the Safeguard Mechanism, if you have any questions please contact me on 02 6272 1555 or Dougal Torrance on 02 6272 1511.

Yours sincerely



John Bradley
Chief Executive Officer