HOW TO CRACK A NEG – WITH A BIG STICK

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Legal Briefings – By **David Ryan and Robert Nicholson**

Energy regulatory policy in Australia, particularly anything associated with the reduction of carbon emissions, has been a deeply political and tragic landscape for the past 10 years. It has just suffered another set-back.

On 20 August the Prime Minister, Treasurer and Minister for the Environment and Energy jointly announced that the Government's proposed National Energy Guarantee (**NEG**) would no longer include an emissions reduction target. The Government's announcement, which was followed quickly by a challenge to Prime Minister Malcolm Turnbull's leadership, follows several weeks of public spats between the Federal and State/Territory Governments, internal fighting within the Liberal National Coalition Government and numerous changes to the proposed NEG design to try and appease the various stakeholders.

A vocal minority within the Liberal party room believe that any form of emissions reduction target will damage the Australian economy for no material benefit to the environment, and should not be adopted unless other nations adopt similar measures. The Prime Minister had just days earlier announced that the NEG emissions reduction target would be introduced via Ministerial regulation rather than legislation. This was to avoid a parliamentary vote on a legislative mechanism and the unedifying sight of members of the Government crossing the floor of the parliament to vote it down.

Now the emissions reduction component is gone altogether - on the open acknowledgment that in a parliament where the Government holds only a one-seat majority, the Government alone could not deliver it.

Several of the States have declared that the NEG, as we knew it, is now finished. The NEG's dead, baby. The NEG's dead.

SO WHERE DOES THIS LEAVE EMISSIONS REDUCTIONS?

The NEG was introduced as a mechanism to address the “energy trilemma” (to borrow a phrase from Professor Allan Finkel, Australia’s Chief Scientist) of emissions reductions, system security and energy affordability.

The NEG was always a “Plan E” option (at best), intended to at least achieve something while attempting to avoid the ideological perils of being called a emissions trading scheme, emissions intensity scheme or actually providing a mechanism to put a price on carbon. It provided an incentive for future renewable energy development via an emissions target component, with obligations to be placed on electricity retailers in the National Electricity Market (**NEM**). The Government claimed that the NEG would also result in a reduction in retail electricity prices – solving the energy trilemma, although some commentators disputed the modelling underpinning this claim.

The emissions reduction element of the NEG was modelled on a target of 26% reduction in carbon emissions from the electricity sector below 2005 levels by 2030. This was consistent with the economy-wide emissions reduction target of 26-28% agreed at the Paris climate conference in 2015 by then Prime Minister, Tony Abbott. Mr Abbott, one of the key Liberal party room dissidents, has since advocated repealing the Paris agreement commitment on the grounds that it had been made on the basis of faulty analysis and advice, and because the USA had since withdrawn from the Paris agreement and it appears many other countries will not meet it.

The Labor opposition had not committed to whether it would or would not support the NEG. However, it had announced a policy of a 45% emissions reduction target from the electricity sector (presumably via the NEG mechanism, which provided the mechanism for future scalability). Labor policy appeared to be based on the notion that if a 26% emission target would result in a reduction in retail electricity prices, then surely a 45% target must lower retail electricity prices even further.

Just to prove that you can’t please everyone all the time, Labor’s 45% target caused outrage from the Greens party (a potential future coalition partner with Labor) as timid and lacking necessary ambition. The Greens want a total economy-wide emissions reduction target of 63-82% by 2030, with the stationary energy sector to bear a larger part of this.

Meanwhile, the Renewable Energy Target of 33,000 GWh of renewable electricity generation by 2030 (the **RET**) has already been achieved. The RET has been the primary driver of a boom in renewable energy project development in Australia over the past 4 years. However, unless expanded or extended, the RET will not support further renewables generation investment. The renewable energy industry had therefore hoped that the NEG would provide the fillip required to maintain progress with renewable energy development in Australia.

Without the RET or an emissions reduction component to the NEG, the issue is now whether the incentives for renewable energy development are sufficient to avoid a reduction in renewable project activity. While much has been made about the prices for offtake agreements from wind and solar projects reaching parity with thermal generation, these comparisons can be misleading and often do not consider the associated network and system security impacts and costs of "firming" intermittent renewables generation. Without any form of increased RET or NEG incentive, the Australian renewable energy sector is likely to face a period of reduced activity until further retirements of the existing coal fired generation. Any further incentives to the renewable energy sector in Australia now depend on the States developing their own schemes, or on a change in the Federal Government.

WHAT ABOUT SYSTEM SECURITY?

Quite where the recent announcement leaves the reliability aspects of the NEG is unclear. The Prime Minister noted:

"The National Energy Guarantee, as you know, was primarily designed as a response to the South Australian blackouts and the need to ensure that there was greater reliability or assured reliability in the energy market. That's the most pressing issue and as the Energy Security Board has said, needs to be in place by July 2019. It's not far away. Now, the absence - if that remains the case - of federal legislation on emissions intensity does not prevent the States from pressing on with the reliability guarantee. That in itself is also a very important tool to get power prices down."

This statement seems to indicate that the reliability issue is now being left for the States to address through the usual NEM mechanisms. System security appears to be, from the Federal Government's perspective at least, the least loved of the three trilemma sisters.

The Prime Minister went on to say that:

"the key thing that is driving the reliability component is the reliability guarantee. That is the function of State legislation and they should proceed with that."

The reliability aspect of the NEG is less political, but is substantially more complex. It attempts to create an incentive to encourage the contracting of additional "reliable" generation, or additional demand reduction, where the energy market operator identifies a future reliability gap in a specific jurisdiction. The complexity comes from allocating this responsibility among retailers, then clubbing them together to do something about it, and how long this incentive should last. The key concern with the reliability aspect of the NEG is that it will simply end up as a revised form of the Reliability and Emergency Reserve Trader function that already exists under the National Electricity Rules.

One silver lining from the removal of the emissions reduction target from the NEG may be that the Energy Security Board can now focus on ironing out the details of the reliability guarantee, to ensure it can provide an efficient reliability mechanism without unnecessary compliance costs. The removal of the emissions reduction target may allow the reliability guarantee obligations to now sit where many consider they logically belong - on generators rather than retailers.

A BIG STICK, FOR THE “BANDITS”

The Government used its announcement of the withdrawal of the emissions reduction target from the NEG to quickly try to shift attention onto something else – high retail energy prices.[1] For this it solely and directly blamed the large vertically integrated energy retailers.

First, the Prime Minister stated that **"*cheaper power has always been our number one priority when it comes to energy policy,*"** noting the ACCC’s recent inquiry into the supply of retail electricity and the competitiveness of retail electricity prices.[2] The Prime Minister then claimed that the ACCC inquiry **"*confirmed what we knew, that the big energy companies were gaming the system to make huge profits*"** and referred to **"*rampant price gouging by the big energy companies*"**.

The Hon. Josh Frydenberg, Minister for the Environment and Energy went on to say:

“Now, for too long, the energy companies have made out like bandits. In fact, some of the companies have tripled their profits as struggling Australian families have tried hard to meet their power bills."

The energy companies (and the business community generally) had consistently backed the NEG and called for political consensus to ensure it was passed. It must be particularly galling for them that they have now being made scapegoats for the Government’s failure to pass the NEG. Further, the ACCC review, while noting the impacts of generation market concentration (an issue not confined to the private sector’s “big three”), did not at any point suggest that the large vertically integrated energy retailers have been “gaming” the wholesale market, although it did advocate additional powers to take stronger action on gaming.

Nevertheless, the Hon. Scott Morrison, Treasurer, outlined three proposed initiatives to reduce the role of the energy companies in high retail energy prices:

“Three things, safety net, second, a big stick to keep the big companies in line and thirdly, backing investment in new generation through the recommendations of the ACCC...

The big stick, as we've referred to it, involves a number of powers ranging everywhere from the initial warning up to divestment and everything in between. Enforceable undertakings, instructions, directions in terms of making supply available in the wholesale market. All of this is on the table based on the advice that we received from the ACCC and others for the Government to actually act. And, that's the big stick."

The first of these, the safety net, involves setting a default market offer from which any discounts in retail electricity prices offered by retailers must be calculated. The ACCC also proposed that the AER should be given the power to set a maximum price for default market offers in each jurisdiction – essentially a regulated price cap for default customers. This maximum price would be the AER's view of the efficient cost of operating in a jurisdiction, including a reasonable margin and customer acquisition and retention costs.

The potential reintroduction of price caps is a backwards step and creates some serious concerns. Electricity pricing has never been within the jurisdiction of the ACCC/AER – it has always been a matter for the States and the AER's role has been limited to determining regulated network revenues and pricing. Virtually all State regulation of retail prices has been abandoned due to its effect of stifling competition. The AER is not currently qualified to perform such a role and its likely approach to that role is unclear. If it is anything like the issues that have affected the AER's regulation of network revenues, then there is likely to be widespread concern among retailers.

More importantly, regulated price caps are dangerous in a volatile wholesale market environment where there are acknowledged issues regarding system security. The retail margin is only a small part of retail electricity prices – more significant are the wholesale electricity cost and network charges components. A cap on the bundled charges to consumers, set by a regulator that has already shown it is willing to bow to populist pressure in setting network charges yet avoid accountability for its decisions through review mechanisms, will significantly increase the risks faced by all electricity retailers. This is likely to particularly affect the smaller retailers who do not have their own generation cover.

However it is the statements about the use of a "big stick" that are the most concerning. The Government proposes that the AER should be provided with additional powers for where there has been an abuse of market power by energy companies (something that is already illegal under the *Competition and Consumer Act 2010* (Cth) if it has the purpose, effect or likely effect of substantially lessening competition). These powers will include directing the operations of industry participants, functional separation and, "as a last resort", the divestiture of assets.

Direction of operations could include a direction to keep generating plant open, potentially reviving the spat between the Government and AGL Energy over the planned closure of the aging Liddell power station in NSW. Divestiture was described by the ACCC as "an extreme measure to take in any market" and was not one of the ACCC's recommendations. It seems very unlikely that the Government would ever take such drastic and unprecedented steps, but statements such as these will have a significant impact on how Australia is perceived as an investment destination and the levels of regulatory risk associated with Australia.

The last element is that the Government will underwrite investment in new, competitive dispatchable generation. This was a recommendation of the ACCC review, but the details and criteria for deployment have not yet been set out. These measures have the potential to suck oxygen from investment in generation that is not supported by the Government.

To monitor the effectiveness of these reforms, the ACCC has been directed to undertake a public inquiry into the prices, profits and margins in the National Electricity Market, which will continue until 2025. Further reforms may flow from this monitoring leaving the industry in a persistent state of uncertainty for the foreseeable future.

REGULATORY UNCERTAINTY AND THE IMPACT ON INVESTMENT

These interventions are attempting to address fundamental issues that have nothing to do with the role of the large vertically integrated energy retailers. The real reasons for high retail electricity prices are complex and manifold, and include:

- retirement and closure of the base-load coal fired plant and the increasing unreliability of such plant as they reach, and exceed, their original design lives;
- the loss of gas as a source of competitive generation and essential support for intermittent renewable generation. On-shore fracking moratoriums and the diversion of coal seam gas to the Queensland LNG projects has seen domestic gas supplies reach export parity pricing and supply limitations (and proposals for the development of LNG import terminals, which will assist to secure reliable supply but will not reduce prices below international parity);
- continued Government ownership of some sectors limiting potential competition;
- significant increases in solar and renewable generation but a lag in the policy framework being able to accommodate large volumes of intermittent generation;
- significant increases in rooftop solar PV generation due to the subsidies afforded to it under both the RET and State schemes;
- States setting unnecessarily high network reliability standards and retaining network assets in State ownership;
- poor allocation of transmission and distribution costs among customers resulting in significant cross subsidies to some classes of customer (especially those with solar PV and air-conditioning);
- a lack of meaningful enhancement of the transmission capacity between regions and an inadequacy of the current National Electricity Rules to accommodate transmission

network development; and

- a lack of general energy policy certainty increasing regulatory risk in the Australian energy sector.

The Australian energy industry has suffered from short term and changing energy policy for a long time. This has created a “sawtooth” profile of generation plant investment as regulatory settings are continually changed.

The lack of policy certainty is not confined to electricity generation. Recent reforms to network regulation by the AER jeopardise legitimate investments in the networks sector, again for the sake of reduced power prices. These include the abolition of limited merits review of the AER’s network revenue decisions and new rate of return guidelines which empower regulators to set prices with little or no accountability for their decisions.

There are now calls for regulated asset bases to be “optimised” and expose network owners to the risk of assets being stranded. There is a material risk that the rates of return permitted to network businesses no longer reflect the level of regulatory risk to which those businesses are exposed.

We are now witnessing unprecedented levels of Federal Government involvement in the electricity sector (noting that the sector was largely the domain of the State Governments before disaggregation, deregulation and privatisation in the late 1990s and early 2000s). The Government has recently taken a 100% holding in the country’s largest peaking generation provider – Snowy Hydro Limited, proposed to fund the Snowy 2.0 pumped hydro development. It now proposes writing offtake agreements for other new, competitive dispatchable generation.

This investment, and the “big stick” approach to the large energy retailers, appears to be reacting to the symptoms of this market dysfunction (high retail electricity prices) rather than the root causes. This approach is only likely to provide a short term respite. The answer to a sustainable and efficient energy sector lays in providing long term policy certainty, ensuring risks and returns are appropriately matched and providing an environment that will encourage maximum competition.

REFERENCE TO EARLIER HSF ARTICLES ON THE NEG:

https://www.herbertsmithfreehills.com/latest-thinking/the-finkel-review-beyond-the-clean-energy-target

https://www.herbertsmithfreehills.com/latest-thinking/finkel-review-gas-could-be-the-transition-fuel-in-the-move-towards-a-low-emission https://www.herbertsmithfreehills.com/latest-thinking/finkel-on-the-future-australia-to-renew-its-energy-policy-and-recharge-investment

https://www.herbertsmithfreehills.com/latest-thinking/release-of-national-energy-guarantee-consultation-paper

https://www.herbertsmithfreehills.com/latest-thinking/federal-government-energy-policy-update

https://www.herbertsmithfreehills.com/latest-thinking/national-energy-guarantee-will-it-keep-the-lights-on

ENDNOTES

1. A transcript of the press conference is set out at https://www.pm.gov.au/media/press-conference-treasurer-and-minister-environment-and-energy-0

2. https://www.accc.gov.au/publications/restoring-electricity-affordability-australias-competitive-advantage

KEY CONTACTS

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