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Greenhouse Gas Reduction Scheme Transition Review
Department of Water and Energy
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Dear Sir / Madam

NSW Greenhouse Gas Reduction Scheme

The National Generators Forum (NGF) welcomes the opportunity to comment on the Department of Water & Energy's *Transitional Arrangements for the NSW Greenhouse Gas Reduction Scheme, Consultation Paper*, released on 1 April 2008.

The NGF represents the 21 major power generators in Australia's National Electricity Market (NEM). NGF members have made investment in more than 45,000MW of installed capacity, with an asset value of more than \$40 billion. Annual sales are over 192,000 GWh, with a value of around \$12 billion. This is about 95 per cent of the total Australian market.

The NGF's membership encompasses coal, gas, diesel, wind and hydro electricity generators. As the peak industry body for Australia's electricity generators, the NGF has a strong interest in the development of energy and climate change policies which impact on the sector.

National emissions trading scheme

The NGF supports the establishment of a broad-based national emissions trading scheme. It makes sense to have a single, national scheme designed around a market instrument that sends price signals across all sectors of the economy to encourage the lowest cost greenhouse gas abatement and to drive the efficient use of energy.

The NSW GGAS scheme has worked very well to date. It has provided the incentive for a range of participants to invest in a variety of generation, demand-side and sequestration projects. GGAS has demonstrated that a market mechanism with clear rules and reporting obligations can deliver substantial results in terms of abatement activity from relatively low cost sources.

While GGAS has performed well, the NGF has consistently supported a national approach led by the Commonwealth Government in preference to a mix of state-based schemes that create multiple obligations on participants in the electricity sector.

The establishment of a national scheme with progressively tighter targets over several decades will have a major financial impact on the more emission-intensive generators operating throughout Australia. While a significant portion of the additional cost of acquitting permits under a national scheme will be passed onto customers, many generators will not be able to recover all of the additional impost.

The NGF's support for a national scheme is conditional on the provision of an administrative allocation of permits to adversely impacted generators to offset the inevitable losses in revenue for higher emission plant. It is important to point out that generators are not asking for an allocation of permits to cover all of their past emissions or likely future emissions, rather the number of permits provided for free would reflect the reduction in net revenues relative to a business-as-usual base case without an emissions trading scheme.

Objectives for a transition plan

The NGF supports the NSW Government's decision not to duplicate the task of a national emissions trading scheme by continuing to operate the GGAS scheme through the period to the end 2012 as was originally planned. The Commonwealth Government should fully support this decision as it will reduce the administrative and compliance costs of delivering an overall national environmental target. These savings will inevitably flow through to consumers. The Commonwealth must also be mindful of the significant investments that participants have made under the GGAS scheme in the expectation that they would receive a revenue stream from the trading of abatement certificates over the period to the end of 2012.

The NGF agrees with the proposed objectives for a GGAS transition plan as outlined in the consultation paper. Effectiveness and efficiency are obvious goals for the planning of any new policy program that replaces an existing scheme under which participants have made significant financial commitments.

An equally important criterion is the need for regulatory certainty and investor confidence in carbon markets. In order to achieve significant long term reductions in greenhouse gas emissions, Australia will require a huge amount of new investment in low emission technologies. Modelling work commissioned by the NGF shows that the market will require some \$130 billion in new plant and equipment in order to meet 60% cuts in greenhouse emissions in the electricity sector by 2050.

New and existing investors may be reluctant to make such large financial commitments if there is a genuine concern that the market rules can change without adequate warning causing a significant reduction in the value of those investments. Government commitment to offset the financial impacts of major changes in greenhouse policy would improve investor confidence, strengthen the credibility of the trading scheme and lower the risk premiums that investors would require for new projects.

Treatment of accredited abatement certificate providers

Over the past five and half years of the GGAS scheme, generation projects accredited under the Generation Rule have reduced emissions in Australia by more than 45Mt. These investments have made a material contribution to Australia's efforts to satisfy its Kyoto targets.

When GGAS was first established in 2002, investors were aware that the regulatory framework for the scheme would only operate until 2012. When the NSW Government amended the relevant legislation in 2006 to extend the scheme, it was clear that GGAS would only operate beyond 2012 if the state or federal governments had not implemented a national emissions trading in that time. NGF members are concerned to ensure that projects undertaken in the expectation of earning NGAC revenues up to the end of 2012 are not materially disadvantaged by the earlier implementation of a national scheme.

The State's National Emissions trading Taskforce and the Prime Minister's Task Group on Emissions Trading both proposed to provide an up-front allocation of permits on a plant by plant basis to offset the loss of net revenues associated with the introduction of a national scheme. For the past three or more years in which these proposals have been discussed and developed, investors have factored in an expectation that governments would take account of the economic impact of a national scheme on pre-existing investments.

The NGF is currently undertaking modelling work examining the revenue impacts of different scheme caps for each generator in Australia. The modelling work involves an assessment of cost-pass through levels and changes in the dispatch order on generator returns under a business as usual base case and various emission caps. Preliminary results indicate, not unexpectedly, that higher emission plant, most notably brown and black coal generators, will face significant reductions in value relative to the base case. The NGF understands that the Commonwealth Government is also undertaking a similar modelling exercise to quantify the impact of different emissions trajectories on various sectors of the economy.

The NGF recognises that the calculation of the number of administratively allocated permits to offset the reduction in the value for seriously affected businesses will involve a number of assumptions about how the market will develop over an extended period. Nevertheless, industry experience with recent modelling exercises demonstrates that the modelling task is a manageable exercise that can be completed in a period of several months. The NGF is willing to cooperate in any way possible to assist the Commonwealth's modelling team, including the provision of detailed industry data.

The NGF considers that the best way to treat to existing GGAS investments would be to factor anticipated NGAC revenues into the base case for each generator as part of the exercise of determining the expected loss of market value. There are two key factors that will determine the relative financial impact of the change from a baseline and credit scheme to a new national cap and trade scenario:

1. the likely change in wholesale electricity prices during the period 2010 to 2012 under an emissions trading scheme. This will depend in large part on the expected price of permits and the level of cost-pass through that different generators can achieve;
2. the expected price of NGACs during the period 2010 to 2012 that is built into the base case (discussed in the following section).

A GGAS project should qualify for transitional assistance in the following circumstances:

If	<i>The NGAC revenue that the project could have earned in each year of scheme overlap between 2010 to 2012 (expected NGAC price x number of expected abatement certificates)</i>
Is greater than >	<i>The net impact of the cap and trade scheme: the benefit of a higher wholesale price on the entire output of the project less the cost of purchasing permits for the emissions from that project</i>
Then =	<i>Transitional assistance should be paid on the net loss of GGAS revenue</i>

It is possible that a number of low emission GGAS projects would benefit more under a cap and trade scheme if the wholesale price impact of emissions trading is relatively large. In these cases, no transitional assistance would be necessary.

The NGF recognises that this modelling exercise is heavily dependent on the assumptions about NGAC prices, permit prices and wholesale price changes. It is not possible to form a confident view on likely price impacts until more is known about the trajectory of the emission caps in the early years of the national scheme as well as penalty settings, eligible offsets and linkages to other international schemes. Therefore it is not possible to confidently predict whether generators with GGAS investments would be better off under either scheme. Given the level of uncertainty, the NGF would like the NSW Government to pursue an in-principle decision with the Commonwealth Government to the effect that it will build GGAS revenues into its base case analysis when assessing loss of market value.

The NGF also recognises that there may be an issue about the scale of the modelling task if all projects developed under the GGAS Generation Rule are included in the calculation of free permits. The NGF considers that the Commonwealth could develop a rule based on the size of the project when deciding whether to measure the impact on asset value. One possible threshold could be to set the limit based on whether the generation project is above 30MW, the limit for scheduled generators in the NEM. This would reduce the number of eligible projects and significantly simplify the modelling task.

Unused abatement certificates

The NGF supports the concept of converting unused NGACs into national emission trading scheme permits when the GGAS is terminated. This position is consistent with our view that participants should not be adversely impacted by the decision to abolish GGAS prior to 2012.

There is an issue over the basis for making the conversion of NGACs into permits. Current NGAC prices have been impacted by the ongoing uncertainty about the treatment of surplus certificates. Any announcement by the Commonwealth on how it may recognise NGACs will have an immediate impact on NGAC prices. The Commonwealth needs to settle on a decision rule that does not encourage gaming of the NGAC market and provides a reasonable estimate of the value of permits that it can factor into the calculation of administered permits over the period to 2012.

The NGF agrees that the method for converting permits should not create incentives for participants and traders to withhold NGACs to the extent that participants fail to comply

with GGAS obligations. Any decision rule will involve some degree of subjectivity, but some options would be less arbitrary than others and enable the smooth transition to a national scheme without major disruption to the NGAC market.

The NGF's preferred method would be to base the conversion rate on a one-for-one recognition of NGACs for national permits at the end of the scheme. As noted in the consultation paper, if the conversion of permits reduces the number of permits allocated under the national trading scheme by an equivalent amount, there is no diminution of environmental outcomes under this approach.

If a straight one-for-one conversion is not acceptable to the Commonwealth, an alternative would be to apply the relevant GGAS penalty fee at the time the GGAS scheme terminates (adjusted by the company tax rate to reflect the fact that penalties are not a taxable expense). The conversion rate may require some small discount to the penalty rate to encourage benchmark participants to acquit permits. Under this approach, by way of example, if the GGAS penalty fee was half the expected or actual permit price at the time the national scheme commenced, then participants would receive one-half of a national permit for every surplus NGAC held. Similarly, if the permit price was equal to the NGAC penalty fee, this method would be equivalent to a straight one-for-one conversion.

Another way of setting the conversion rate would be to take a longer term average of NGAC prices, possibly over the life of the GGAS scheme. This averaging approach would reduce the impact of uncertainty relating to the treatment of surplus NGAC that has influenced NGAC prices in the latter years. NGAC holders would be able to reasonably estimate likely conversion rates as uncertainty over prices in the final years would have a smaller weighting in the calculation of the actual conversion rate.

The early announcement of how the Commonwealth intends to deal with surplus NGACs at the end of the scheme has the potential to alleviate a major problem emerging in the electricity market. Ongoing uncertainty about the timing of a national trading scheme, the level of emission caps and the likely level of permit prices is reducing liquidity in the various electricity derivative contract markets. Generators, retailers and traders are finding it increasingly difficult to agree on a carbon price for contracts in 2010 and beyond. Reduced liquidity can result in higher prices for customers and the use of higher risk premiums by investors unable to hedge the output of new projects.

A decision to recognise NGACs on the basis of a tonne for tonne conversion, the relevant penalty rate or an averaging of NGAC prices would encourage greater contracting in the forward market if it helped with permit price discovery. This could be a major flow-on benefit for all participants from joint NSW and Commonwealth agreement on a preferred approach to the key transitional issues.

New accreditations

The NGF supports the consultation paper proposal to set a cut off date of 1 September 2008 for projects to qualify for transitional assistance. This should include projects that had satisfied the definition of committed project at that date, as detailed by NEMMCO in its statement of system opportunities.

All new projects that are eligible to create abatement certificates under the existing GGAS rules should be able to produce and trade certificates up until the NSW scheme ends.

Ending liability under the GGAS

The NGF supports the termination of the GGAS immediately prior to the commencement of a national emissions trading scheme – preferably the trading day before the national scheme starts. The Commonwealth Government has not finalised a start date for the scheme at this stage, but this should be settled in the first part of 2009 when the Government proposes to consider the enabling legislation. It is possible that the national scheme could start 1 July 2010 which would clash with the calendar year reporting cycle for GGAS.

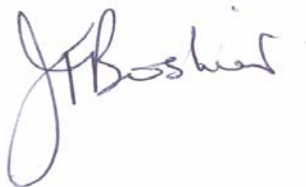
The greater the period of notice for benchmark participants on key matters like scheme start and the treatment of surplus certificates, the lower are the compliance costs for industry and consumers. It should also encourage a more liquid market for GGAS certificates if participants have good information on their obligations and the validity of certificates that have not been surrendered.

Next steps

The NGF would encourage the NSW Government to fast track discussions with the Commonwealth Government on possible GGAS transition plans. The Commonwealth has flagged that it will release a green paper in July 2008 detailing its preferred approach on a range of implementation and design issues. It would be good for all concerned if the green paper included proposed details on how the Commonwealth intends to treat projects undertaken in response to the GGAS scheme and how it may recognise unused NGACs.

The NGF welcomes further opportunities to interact with the NSW Government on these issues and we look forward to discussions at the next consultative group meeting in May 2008. If you wish to discuss this submission further please contact Russell Skelton, 02 49687447, or via email (russell.skelton@macgen.com.au).

Yours sincerely



John Boshier
Executive Director