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Mr Stan Krpan,
Chief Executive Officer, Solar Victoria
Department of Environment, Energy and Climate Action
150 Lonsdale Street
MELBOURNE VIC 3000

29 November 2024

Dear Mr Krpan,

REGULATORY IMPACT STATEMENT FOR THE VICTORIAN ENERGY EFFICIENCY TARGET AMENDMENT (TARGETS) REGULATIONS 2025

I would like to thank your staff at the Department of Environment, Energy and Climate Action (the Department) for working with the team at Better Regulation Victoria to prepare a Regulatory Impact Statement (RIS) for the proposed Victorian Energy Efficiency Target Amendment (Targets) Regulations 2025.

As you know, the Commissioner for Better Regulation provides independent advice on the adequacy of the analysis provided in all RISs in Victoria. A RIS is deemed to be adequate when it contains analysis that is logical, draws on relevant evidence, is transparent about any assumptions made, and is proportionate to the proposal's expected effects. The RIS also needs to be written clearly so that it can be a suitable basis for public consultation.

I am pleased to advise that the final version of the RIS received by us on 29 November 2024 meets the adequacy requirements set out in the *Subordinate Legislation Act 1994* (the SLA).

Background and problems

The Victorian Energy Upgrades (**VEU**) program is a market-based energy efficiency incentive scheme that subsidises energy-efficient upgrades for households and businesses. The VEU program was established under the *Victorian Energy Efficiency Target Act 2007* (**Act**). The program is overseen by the Department and regulated by the Essential Services Commission (**ESC**). The program objectives set out in the Act are to

reduce greenhouse gas emissions, encourage the efficient use of electricity and gas, and encourage investment, employment and technology development in relevant industries.

Under the *Climate Change Act 2017*, Victoria has a legislated target of net zero greenhouse gas emissions by 2045. The Department highlights that the Victorian Government is considering future VEU targets alongside other energy efficiency policy initiatives to achieve emission reductions, including:

- proposed minimum energy efficiency standards for rental homes, which were analysed in a RIS in 2024
- building electrification requirements mandating the replacement of gas appliances with electric appliances, which were initially proposed for further analysis in the 2023 update to the Victorian Government's Gas Substitution Roadmap.

Decisions on both policies will be confirmed after publication of the RIS for 2026 and 2027 VEU targets.

The Department highlights that:

- the energy efficiency measures supported by the VEU program achieve emissions reductions at relatively low costs by reducing energy demand, particularly at peak times
- reduced electricity demand lowers the overall investment in new generation, transmission and distribution infrastructure required to decarbonise the electricity grid
- without further reductions in energy demand, it may be challenging for Victoria to meet its legislated target of net-zero emissions by 2045.

The Department explains that without an incentive program several barriers exist to the uptake of energy efficiency upgrades. These include:

- lack of consumer knowledge regarding options to improve energy efficiency
- split incentives through which the costs and benefits of potential upgrades accrue to different parties: for example rental providers bearing the costs of upgrades but tenants benefiting through reduced energy bills
- up-front costs which deter investments that would deliver long term savings
- externalities such as the costs of greenhouse gas emissions not being directly reflected in the energy prices paid by consumers.

The Department explains that the VEU has served to address lack of consumer knowledge by promoting awareness of energy upgrades and has helped address split incentives and externalities by reducing the upfront costs and improving the availability of upgrades for commercial and industrial businesses, household owner occupiers, renters and rental providers.

The program involves the installation of energy efficiency upgrades by authorised private businesses known as Accredited Providers (**AP**s). By providing energy efficiency upgrades approved under the scheme, APs generate Victorian Energy Efficiency Certificates (**VEEC**s). Each certificate represents one tonne of abated carbon emissions. Currently, certificates can only be generated for upgrades that lead to additional energy savings that would not have occurred without program incentives. APs sell VEECs to energy retailers, which are required to obtain and surrender a set number of VEECs per year to meet annual emissions reduction targets set by the Victorian Government. A retailer that fails to surrender sufficient VEECs will incur a shortfall penalty (set at $90 for 2023), multiplied by the number of additional certificates needed to meet its annual obligation. Historically, VEU targets have been set for a period of five years.

The Victorian Energy Efficiency Target Regulations 2018 (VEET Regulations) are made under the Act and currently prescribe the target levels for Greenhouse Gas (**GHG**) emissions from 2022 to 2025. The Department explains that:

- The Minister for Energy and Resources must have regard to the yearly targets when setting the carbon dioxide equivalent Greenhouse Gas Reduction Rates (**GGRR**) for a particular year.[1]
- Because the yearly GGRR determines the liability for meeting the yearly targets proportionately amongst liable retailers.[2] Therefore, the analysis undertaken within the RIS regarding costs, benefits and target options for 2026 and 2027 is also relevant to the Order to set the GGRR for those years.

The Department explains future decision-making about the VEU Program is being informed by three pieces of analysis:

- The RIS assessed in this letter, which considers target options for 2026 and 2027;
- A program evaluation reviewing VEU's performance against its objectives; and
- A strategic review currently being developed to consider future VEU policy direction and target levels from 2028.

The Department explains that the 2019 RIS assessing VEU targets for 2020 to 2025 committed to a comprehensive program evaluation. The evaluation is assessing the program's performance, the distribution of its costs and benefits, and incorporates perspectives from industry and consumers. The Department explains that it is currently conducting a separate strategic review of the VEU program, which will inform decision-making on the 2028 target. The review is considering the future policy objectives and target setting under the program.

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[1] Section 32(1) of the VEET Act provides for the Governor in Council to fix the greenhouse gas reduction rates for electricity and for gas by Order published in the *Victoria Government Gazette*, on the recommendation of the Minister. The rates must be set by no later than 31 December each year.

[2] The number of VEECs each retailer must surrender for a year is calculated by the GGRR for electricity and gas multiplied by the quantity of electricity and gas sold to the relevant customers in that year

The Department explains that:

- targets were last set for a five-year period from 2021 to 2025 with the Act requiring new targets to be set by no later than 31 May 2025
- the strategic review could recommend significant changes to the VEU scheme, such as revising its objectives.

The Department therefore explains in the RIS that it is seeking to amend the Act to set targets for less than five years to allow target setting for 2028-30 to occur in May 2027 (or a later date to be determined) and incorporate the findings of the strategic review. The RIS assessed in this letter considers options for setting VEU targets for 2026 and 2027. It notes that 2026 and 2027 targets must be set before 31 May 2025 to ensure the continued operation of the program. It also notes that failing to set new targets may lead to reduced consumer and stakeholder confidence in the VEU program, which would not only remove program benefits but also cause structural adjustment costs as the existing industry adjusts to the abrupt removal of a market for VEECs.

Options and impact analysis

The Department analyses options for setting targets for the VEU program for 2026-2027 under two potential regulatory scenarios.

- a **main regulatory scenario** under which government proposals which have been publicly announced but not yet formally implemented are assumed to proceed, namely:
    - an end-of-life ban on replacing residential gas heating and hot water appliances
    - updated minimum energy efficiency standards for rental properties
    - passage of an additionality amendment to the Act.
- an **alternative scenario** based only on current regulatory settings.

The Department presents low, medium and high target options under the main regulatory scenario and low and medium target options under the alternative scenario. It explains that the targets and assumptions about eligible activities differ between the core and alternative scenarios based on anticipated differences in demand for upgrades.

The Department analyses the following options for VEEC target levels:

- target option 1: 4 million in both 2026 and 2027
- target option 2: 5 million in 2026 and 6 million in 2027
- target option 3: 6 million in 2026 and 7.3 million in 2027
- alternative option 1: 4 million in 2026 and 4.5 million in 2027
- alternative option 2: 4.5 million in 2026 and 5 million in 2027.

Across options, the Department assumes relevant policy settings vary with the target level. For example, more extensive eligible activities are assumed to be available at higher target levels to represent a realistic mechanism for APs to generate more VEECs.

The VEU policy settings that the Department assumes vary between options are:

- Additionality – based on whether a proposed amendment to the Act clarifying that VEU incentives can be used to meet other regulatory requirements passes.
- Activities – based on the type of upgrades incentivised under the program.
- Target trajectory – whether the target is the same in both years or increases from 2026 to 2027.
- Fees – based on adjustments to program fees to allow the ESC to achieve full cost recovery at a given target level.

The Department compares options using a cost-benefit analysis (**CBA**). Options are compared against a reference case equivalent to setting a VEEC target of 0. The Department explains that a reference case is used instead of a base case of no targets being set in regulations (which would reflect the typical approach in a RIS), because the Minister for Energy and Resources is obliged to set targets under the Act.

Estimates in the CBA are derived from economic modelling of the VEEC price associated with each target level and corresponding assumptions about eligible activities. Estimates are also informed by energy market modelling that accounts for the impact of reduced demand for energy due to energy efficiency upgrades.

Prices are estimated to be higher in 2027 than 2026 for nearly all options in line with higher targets for 2027, except for option 1 which has the same target in both years. The alternative scenario has higher VEEC prices because higher incentives would be required to generate a similar level of demand for upgrades in the absence of other mandatory regulatory requirements. VEEC cost estimates in the analysis include VEEC prices plus administrative costs and fees.

Over ten years, the Department identifies the following costs and benefits in its CBA.

Costs:

- costs of energy retailers acquiring VEECs, which are passed through to consumers via retail electricity bills – ranging from $351 million to $1.1 billion
- out-of-pocket costs to consumers and business customers associated with VEU upgrades for their properties
- costs to the Government of overseeing the program (excluding day-to-day administration costs, which are assumed to be fully recovered by program fees); and
- foregone profits of energy retailers due to reduced energy demand.

Benefits:

- avoided carbon emissions
- energy bill savings for consumers due to reduced energy consumption
- lowering of energy prices caused by reduced demand
  profits for APs installing upgrades.

The profile of costs and benefits across options is characterised by:

- higher costs, benefits and net benefits as targets increase within each scenario
- higher costs, benefits and net benefits for a given target level in the alternative scenario than the core scenario, although with a lower benefit-cost ratio (**BCR**).

The most significant benefits identified are bill savings for residential and business consumers, ranging from $969 million for core option 1 to $3 billion for alternative option 2. The most significant cost category comprises pass-through costs to consumers of between $350 million and $1.1 billion for the same options.

The Department estimates costs and benefit metrics for each option totalling:

- target option 1 - costs of $434 million, benefits of $1.6 billion, net present value (NPV) of $1.2 billion with a BCR of 3.77
- target option 2 - costs of $860 million, benefits of $3.2 billion, net present value (NPV) of $2.3 billion and a BCR of 3.71
- target option 3 - costs of $1.2 billion, benefits of $3.9 billion, net present value (NPV) of $2.6 billion and a BCR of 3.17
- alternative option 1 - costs of $1.9 billion, benefits of $4.8 billion, net present value (NPV) of $2.9 billion and a BCR of 2.52
- alternative option 2 - costs of $2.2 billion, benefits of $5.3 billion, net present value (NPV) of $3.1 billion and a BCR of 2.39.

The Department conducts risk and sensitivity analysis to highlight any variables or assumptions for which uncertainty could drive differences between modelled and actual outcomes. This analysis identifies that risks related to assumptions around consumer preferences and supply chains for electric appliances could mean VEEC prices need to be between $32-$52 higher to achieve targets. The potential impact of risks related to other assumptions on VEEC prices is contained below $10.

The Department also supplements its CBA and modelling with additional qualitative and quantitative analysis covering energy affordability and equity, health benefits and industry investment and innovation. Considering these additional factors and the CBA results, the Department identifies a preferred option under each regulatory scenario.

The Department identifies option 2 as preferred under the main scenario because:

- the difference in BCR between it and option 3 is minimal
- it delivers a high level of benefits including reducing energy bills for all consumers

- it better manages exposure to risks and uncertainty such as potential obstacles to the uptake of electric appliances than option 3.

Under the alternative scenario, the Department prefers option 2 because:

- it outperforms option 1 on the NPV metric
- while it is less favourable in terms of energy bills for non-participants in the VEU program it is more preferred because it leads to greater emission reductions.

Implementation and Evaluation

The Department explains that the proposed targets will be set through amending the VEET Regulations by 31 May 2025 (which is the legislative deadline for setting the post 2025 targets by). The Department explains that it expects the outcome of other relevant regulatory processes to be confirmed prior to this date. The final target amounts might be adjusted if eventual regulatory settings differ from the core scenario. The Department explains that it will undertake work to prescribe in the Regulations new activities and any activities mandated by other regulations which may be eligible to generate VEECs.

The Department explains that it will communicate decisions related to targets and other VEU activities via multiple channels and lead on further consultation. In its role as the program regulator, the ESC will contribute to communicating the changes as well as monitoring and engaging with industry to ensure compliance.

The Department commits to evaluating the operation of the VEET Regulations including the 2026 and 2027 targets ahead of setting the next targets for 2028 to 2030. The Department identifies the following potential data sources for the evaluation:

- certificates created for each activity type and surplus certificates
- VEEC prices
- the number of participating households and businesses
- engagement rates of low-income consumers
- community consultation responses
- additional data sources identified via collaboration with the ESC.

Should you wish to discuss any issues raised in this letter, please do not hesitate to contact my office on (03) 7005 9772.

Yours sincerely,

Cressida Wall

Commissioner for Better Regulation