Business Council of Australia

SUBMISSION

Energy Security Board National Energy Guarantee Draft Design Consultation Paper

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The Business Council of Australia draws on the expertise of Australia's leading companies to develop and promote solutions to the nation's most pressing economic and social policy challenges.

ABOUT THIS SUBMISSION

The Business Council supports the development of an integrated, national and bipartisan energy and climate change policy framework that can deliver the following four key goals:

- secure and reliable energy supply
- affordable energy supply
- strong, internationally competitive economy
- meet current and future absolute emission reduction targets.

In October 2017 the Energy Security Board (ESB) provided advice to the COAG Energy Council on a proposed mechanism that would integrate energy and climate change policy by placing both a reliability and an emissions obligation on electricity retailers – known as the National Energy Guarantee (the Guarantee). In November 2017, the COAG Energy Council agreed that the Energy Security Board should progress further work on the Guarantee and provide advice at the April 2018 meeting of COAG Energy Council.

In February 2018, the ESB published a consultation paper on the proposed 'high-level design options' for the Guarantee. The paper seeks feedback from stakeholders and submissions on the design options presented in the consultation paper.

This submission responds to the ESB's consultation paper on the proposed high-level design of the Guarantee.

KEY RECOMMENDATIONS

The Business Council calls on the COAG Energy Council to support the framework of the Guarantee and work constructively on the next phase of the design and implementation plan.

In relation to the design options, the Business Council makes the following key recommendations to the Energy Security Board and the Commonwealth Government:

- ▶ The Guarantee is a platform for a durable, bipartisan, national emissions reduction policy that can achieve our committed international targets at lowest possible cost while maintaining our competitiveness.
  - The Business Council accepts the Commonwealth Government's national target to reduce Australia's emissions by 26 to 28 per cent below 2005 levels by 2030. Any increase to the target should only be considered as part of the five-yearly review and refine cycles required under the Paris Agreement.
  - The Business Council notes the Commonwealth Government's target for the electricity sector under the Guarantee of a 26 per cent emissions reduction on 2005 levels by 2030. This is consistent with the national target and ensures that the electricity sector is contributing a pro rata share of the national abatement task. The Business Council

encourages future flexibility in setting the electricity sector target in the context of developing a long-term, whole-of-economy emissions reduction strategy to ensure abatement occurs at least-cost.

- The Business Council supports the proposed five-yearly review, and five-year notice period, of the electricity emissions target under the Guarantee as it appropriately balances the need for flexibility to meet future national emissions reduction targets under the Paris Agreement while providing confidence that long-term investment decisions can be made and adequate returns earned in the electricity sector.

- The Business Council supports a single, annual electricity emissions target that will apply across all jurisdictions in the NEM.

- The Business Council does not support state-based schemes operating alongside the Guarantee and implores state and federal governments to reach a nationally coordinated and consistent approach to reducing emissions under the Guarantee. The Business Council believes state-based targets will undermine the Guarantee and drive up electricity prices.

- The Business Council believes that should states wish to pursue their own state-based targets, they should provide a statement of any additional costs that will be imposed on consumers and identify the implications that will arise in relation to system reliability before retailers are required to meet more onerous reliability obligations.

- The Business Council supports maintaining consistency with the RET and exempting electricity used for EITE activities from the emissions requirement under the Guarantee to protect the trade competitiveness of our industry.

- The Business Council supports designing the Guarantee so that retailers have maximum flexibility in complying with the emissions requirement. Any framework that seeks to shift the existing financial market towards physical settlement should be resisted as preserving the liquidity of the market is essential for competition, as well as affordability.

▶ The Business Council supports placing a reliability requirement on retailers to create an incentive to invest in dispatchable generation. The reliability and security of our energy system must be prioritised as we transition to a lower-emissions future.

- The Business Council urges the ESB to adopt a minimalist approach to market intervention when designing the reliability obligation. The costs associated with an intrusive, complex and burdensome mechanism are likely to be significant. Stakeholders have warned against an obligation that effectively results in a ‘gold-plated’ energy market for reliability.

- The Business Council stresses the importance of maintaining liquidity in the electricity contract market.

- The Business Council supports the use of existing financial contracts such as exchange-traded and over-the-counter (OTC) contracts, including caps and swaps, qualifying for meeting the reliability requirement as this will preserve market liquidity.

- The Business Council supports complete transparency of forecast inputs, assumptions and methodology as critical investment decisions will be underpinned by these projections.
- The Business Council supports the ESB designing the Guarantee alongside the development of ongoing reliability work emerging from the Finkel Review, including strategic reserves, day-ahead markets and demand response.

▶ The Business Council supports the implementation of the Guarantee through existing governance arrangements in the NEM, following the agreement of the COAG Energy Council. Such an approach ensures certainty, stability and confidence in the enduring operation of the policy as it is removed from the vagaries of politics and requires widespread agreement to be changed or amended.

▶ The Business Council supports the development and implementation of the Guarantee as part of a suite of energy and climate change policies that will help contain prices, build a more reliable system and meet emissions reduction targets at least-cost. The Business Council supports additional practical measures such as:

- lifting unscientific moratoriums on the development of gas reserves;
- timely major project approval processes to ensure gas supply comes to market as quickly as possible;
- access to credible international permits;
- continuation of the Emissions Reduction Fund; and
- the development of a long-term whole of economy emissions reduction strategy.

INTRODUCTION

Our electricity and gas supplies are the cornerstone of Australia's economy, powering our industries, our cities and our homes. The bulk of electricity and gas produced provides a core input for Australian businesses and therefore affordability and reliability of supply are crucial for supporting competitiveness, job creation and prosperity for Australians.

But substantial changes in our electricity and gas market and a lack of policy certainty has recently resulted in higher electricity and gas prices for all customers and some blackouts. Our immediate focus must therefore be on restoring the security, reliability and affordability of our electricity and gas systems as we transition towards a lower-emissions economy.

To achieve this, we need a clear and comprehensive policy framework to be put in place at a national level. Companies will only invest in new infrastructure in electricity and other key industries if they can see a stable policy framework, with minimal government intervention, that will endure no matter who is in power.

Therefore, the Business Council supports the development of an integrated, national and bipartisan energy and climate change policy framework that can deliver the following four key goals:

- secure and reliable energy supply
- affordable energy supply
- strong, internationally competitive economy
- meet current and future absolute emission reduction targets.

The proposed National Energy Guarantee provides a credible pathway forward. The Guarantee can put an end to the political impasse and policy paralysis and be a circuit-breaker for the stale energy and climate change policy debate in this country.

By relying on existing market structures and placing responsibility for meeting emissions and reliability targets on electricity retailers, the Guarantee is our best chance to drive the investment we need in the energy sector, while also meeting our emissions reduction targets.

Australia's electricity system is undergoing a major transition. An increase in the amount of intermittent technology, such as wind, solar and storage has resulted in a fall in dispatchable coal-fired generation. Since 2012, 5,900MW of ageing coal-fired generation capacity has been withdrawn from the National Electricity Market (NEM) with a further 2,000MW scheduled to close in 2022. In contrast, since 2016, over 6,500MW of new renewable capacity has been announced under the Renewable Energy Target (RET).

This changing mix of generation has led to higher prices and a less stable and reliable energy system. The Guarantee seeks to manage this transition by providing a clear investment signal to build dispatchable electricity generation and encourage the lowest cost range of technologies to meet overall targets.

There remains a considerable amount of detail to work through to ensure the Guarantee is successful, as there would be in any energy plan. The ESB's consultation paper is the next step in the process and the Business Council welcomes the opportunity to provide feedback.

The Guarantee in isolation cannot address all the challenges in the energy sector. The electricity sector cannot bear the total cost of Australia's abatement efforts – doing so will only jeopardise the affordability and reliability of electricity and gas.

A suite of energy and climate change policies is required to help contain prices and build a more reliable system. The Guarantee is just one of these policies. Additional practical measures such as lifting unscientific moratoriums on the development of gas reserves, timely major project approval processes to ensure gas supply comes to market as quickly as possible, access to credible international permits, continuation of the Emissions Reduction Fund and the development of a long-term whole of economy emissions reduction strategy will provide the flexibility and capacity for Australian businesses to ensure adequate supply and meet emissions reduction targets at least-cost.

The Business Council urges Australia's political leaders to work constructively on the design and implementation plan of the Guarantee. Business stands ready to work with governments to get the design of the National Energy Guarantee right and to give the energy sector the certainty it needs.

EMISSIONS REQUIREMENT

The Guarantee is a platform for a durable, bipartisan, national emissions reduction policy that can achieve our committed international targets at lowest possible cost while maintaining our competitiveness.

Electricity emissions reduction target

In 2016 the Australian Government ratified the Paris Agreement and set a target to reduce Australia's emissions by 26 to 28 per cent below 2005 levels by 2030.

Australia is on track to overachieve its 2020 target of reducing emissions by 5 per cent below 2000 levels by 294 Mt CO_2-e and, according to the latest data, Australia's abatement task to meet the 2030 target has reduced by 120 Mt CO_2-e since the 2016 projections.[1]

Emissions on a per capita basis and the emissions intensity of the economy are at their lowest levels in 28 years, having fallen 34 and 58 per cent respectively since 1990.[2] However, data released in December 2017 shows Australia's annual emissions increased 0.7 per cent over 2016-17.[3]

In contrast, 2016-17 annual emissions from the electricity sector decreased 2.2 per cent, with an even larger fall of 3.4 per cent across the NEM in the year to September 2017.[4] This is due to reduced demand, reduced electricity generated from brown coal and increased electricity generated from renewable technology. With electricity generation accounting for about 35 per cent of annual emissions in 2016-17, it is encouraging to see emissions in this sector continuing to fall.[5]

Climate change is a global problem. While Australia only contributes 1.3 per cent of global emissions, through both our 2020 and 2030 targets we are playing our part to reduce emissions and limit the impact of a global temperature rise.

However, policies to address climate change must not come at the expense of a secure, reliable and affordable energy system. Climate change policy objectives must also be grounded in our broader objective to secure Australia's future prosperity and deliver meaningful jobs for Australians. Our climate change policies must therefore support business competitiveness and promote economic growth, both of which are founded on secure, reliable and affordable electricity and gas.

Therefore, the Business Council notes the Commonwealth Government's target for the electricity sector under the Guarantee of a 26 per cent emissions reduction on 2005 levels by 2030. This is consistent with the national target and ensures that the electricity sector is contributing a pro rata share of the national abatement task. The electricity emissions target under the Guarantee balances Australia's emissions reduction goals with the need to prioritise affordable and reliable electricity and gas.

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1 Department of the Environment and Energy, *2017 Review of Climate Change Policies*, December 2017.

2 ibid.

3 Department of the Environment and Energy, *Quarterly Update of Australia's National Greenhouse Gas Inventory: June 2017*, December 2017.

4 ibid.

5 ibid.

The Business Council encourages future flexibility in setting the electricity sector target in the context of developing a long-term, whole-of-economy emissions reduction strategy to ensure abatement occurs at least-cost.

Timing and process for setting the electricity emissions target

The electricity emissions target under the Guarantee must be scalable to meet future emissions reduction targets under the Paris Agreement while balancing investment risk and uncertainty.

As the Guarantee not only imposes an emissions reduction mechanism, but also a reliability mechanism designed to provide a clear long-term investment signal for new dispatchable generation in the NEM, it is essential that the process for setting future targets delivers certainty and confidence for business when making investment decisions. For more than a decade, unstable climate change policy and political wrangling has clouded investment decisions in the NEM. This has resulted in a less stable and reliable system while driving up power prices for business, industry and households.

Australia now requires a bipartisan focus on meeting our international targets. The states, as well as federal political leaders, must work together not just to get the policies right and meet our targets, but to give businesses the long-term policy certainty they need to plan and invest in innovative and more efficient technologies. Encouraging investment in energy generation is the best way to put downward pressure on electricity prices and build a more reliable system. Consequently, the process for setting and updating the emissions reduction target under the Guarantee must be clear, settled and enduring.

The Commonwealth Government sets out the proposed process for updating the electricity emissions target under the Guarantee to align with the five-yearly review and refine cycle under the Paris Agreement. This five-yearly review of the target means that the Commonwealth Government would set at least a further five years of targets under the Guarantee every five years. The initial target trajectory will be set for ten years, from 2021 to 2030, with the first review of the target to take place in 2025.

Additionally, the Commonwealth proposes that any changes to the target trajectory could only apply with five years' notice. This means that, for example, any decision to change the target in 2025 could not apply to the previously set targets from 2026 to 2030.

The Business Council supports the proposed five-yearly review of the electricity emissions target under the Guarantee as it appropriately balances the need for flexibility to meet future national emissions reduction targets under the Paris Agreement while providing confidence that long-term investment decisions can be made and adequate returns earned in the electricity sector.

The five-year review and notice also provides sufficient flexibility in response to changing technology costs, market conditions and changes in demand.

Importantly, the Guarantee's enduring five-yearly review cycle, combined with the five-year notice period, aims to protect investment decisions from the vagaries of politics and changing governments which has resulted in the current policy paralysis.

Geographic neutrality and state-based schemes

The Business Council supports energy and climate change policies that are durable, national, technology neutral and complementary. A single, annual electricity emissions target under the Guarantee, that applies across all jurisdictions in the NEM, achieves these objectives.

A NEM-wide target provides retailers with maximum flexibility to meet their emissions requirement by not restricting emissions generation in particular jurisdictions. Importantly, geographic neutrality will ensure investment decisions in the NEM are not distorted by jurisdictional targets. This NEM-wide approach also recognises the fact that climate change is a global problem and it does not matter where abatement occurs.

For this reason, the Business Council does not support state-based schemes operating alongside the Guarantee. State-based schemes – such as state-based renewable energy targets – distort the operation of the NEM and this can be particularly damaging to the investability, reliability, affordability and long-term transformation of the whole electricity sector, while actually increasing the costs of renewable energy projects. There can be no role for state-based renewable energy targets under the Guarantee.

The Business Council has consistently emphasised the importance of avoiding divergent state-based renewable energy targets. State-based renewable energy targets do not lead to efficient investment outcomes and only serve to drive up the cost of achieving carbon emission abatement at a national level.

Further, the Guarantee also imposes a reliability requirement on retailers. This requirement will apply to retailers in each NEM-region and consequently states that pursue state-based renewable energy targets are likely to disproportionally increase the need for dispatchable resources to support the integration of large volumes of intermittent wind and solar generation in their jurisdiction. This will increase the likelihood of a reliability gap emerging, which will in turn increase the likelihood of the reliability requirement being triggered. Triggering the reliability requirement in a region will result in additional compliance burdens and costs on retailers which will ultimately be borne by the electricity consumers in that state.

Therefore, the Business Council believes that should states wish to pursue their own state-based targets, they should provide a statement of any additional costs that will be imposed on consumers and identify the implications that will arise in relation to system reliability before retailers are required to meet more onerous reliability obligations. This would provide transparency of costs for consumers and ensure that retailers are not held responsible for state government policy decisions.

The Business Council implores state and federal leaders to work together to reach a nationally coordinated and consistent approach to reducing emissions under the Guarantee.

Treatment of EITE activities

The Guarantee must balance Australia's commitment to reduce emissions with the need to preserve our economic prosperity and the trade competitiveness of our industry. These are equally important objectives.

Climate change policy can impact the competitiveness of Australian industry in two key ways:

- *directly* as a result of emissions reduction obligations placed on a company or industry; and/or
- *indirectly* as a result of emission reduction policies impacting key inputs such as electricity and gas.

Since 2015, businesses with emissions-intensive trade-exposed (EITE) activity have been 100 per cent exempt under the RET. This recognises the need to maintain the international competitiveness of Australia's trade exposed sectors, in the context of uneven global commitments to reduce emissions.

In designing the Guarantee, it will be necessary to continue to limit the extent to which these trade exposed businesses contribute towards meeting the emissions reduction target in the electricity sector. As with the implementation of any exemption, management will be required around the practical issues retailers will have in meeting their emissions targets and the costs of compliance.

Therefore, the Business Council supports maintaining consistency with the RET and exempting electricity used to undertake EITE activities from the emissions requirement under the Guarantee, noting that 'to achieve the desired level of overall emissions reductions, non-EITE electricity would need to make up the difference.'[6] In transferring the EITE exemption under the RET across to the Guarantee, consideration should be given to the exemption's application to LNG production.

An important consideration when developing the exemption for EITE activity under the Guarantee will be managing what level of emissions-intensive generation retailers can assign to EITE customers. Can retailers assign the most emissions-intensive generation of their load to EITE customers or will EITE activity be assigned the average emissions intensity across the NEM? This will need to be determined before the electricity emissions targets are set.

Contracting and emissions

The proposed emissions and reliability requirements are designed with 'increased contracting in deeper and more liquid contract markets' in mind. Both components seek to harness existing contract types and to minimise the necessity for product differentiation.

In order to reduce costs and compliance burdens under the Guarantee, retailers, in collaboration with industry more broadly, must have the flexibility under the compliance framework to develop the least-cost, most-efficient method of demonstrating compliance under the emissions requirement.

As highlighted in the consultation paper, contracts that specify a generation source are not standardised and while these specified-source contracts could form part of the portfolio of contracts used by retailers to demonstrate compliance, other methods will also be required.

The consultation paper suggests developing contracts that take the form of a 'stapled security' where a specified amount of emissions per MWh is 'stapled' to the types of

[6] Energy Security Board, *National Energy Guarantee Draft Design Consultation Paper,* February 2018.

contracts currently in existence and regularly traded. Under this framework, generators could produce records of the emissions associated with each MWh generated, which in turn could be linked or attached to retailers' contracts for the specified amount of MWh to be settled, in order to demonstrate compliance under the emissions requirement.

The development of a such a framework would not adversely affect contract market arrangements as existing products such as OTC or exchange-traded swaps would not need to be redefined. It also prevents any move towards physical settlement which would undermine the liquidity benefits of a gross pool by putting a greater requirement on bilateral contracting. Just as the NEM creates a framework for the hedge contracts market to operate so that market participants can manage exposure to the spot market, the design of the emissions requirement framework under the Guarantee must allow market participants the scope to develop the most-efficient, least-cost and innovative method of compliance.

Therefore, the Business Council supports the development of a flexible framework for retailers to achieve compliance under the emissions requirement. Any framework that seeks to shift the existing financial market towards physical settlement should be resisted as preserving the liquidity of the market is essential for competition, as well as affordability.

Flexible compliance options

Carry forward overachievement and deferring compliance

The Business Council supports designing the Guarantee so that retailers have maximum flexibility in complying with the emissions requirement.

Given that the electricity emissions target is initially to be set to 2030, permissible year to year variations and flexibility for retailers to meet their annual emissions requirement will have no material impact on the NEM-wide target in the medium to long term. Greater flexibility and less stringent rules will mean, however, a reduced burden on retailers and a reduction in the costs imposed by the mechanism – costs that will ultimately be borne by business, industry and households.

Proposals in the consultation paper that retailers be permitted to carry forward a portion of a previous year's overachievement for use in the next compliance year, while also being able to defer a portion of the emissions requirement from one compliance year to the next, should be adopted. Such flexible compliance options recognise the need for retailers to manage operational variables.

However, it would be prudent to limit the extent of carrying forward any overachievement or deferring any portion of compliance.

Limiting the amount a retailer can carry forward as overachievement so that overachievement can instead be offered to the market will assist other retailers, particularly the smaller retailers that do not own generation assets and therefore rely more heavily on the contract market to meet the emissions requirement. Creating a market for excess or carry-over emissions will increase liquidity, foster competition in the retail market and, in turn, help put downward pressure on prices. As highlighted earlier, the Business Council supports a flexible compliance framework so that industry can develop the least-cost, most-efficient method of meeting the emissions requirement. Access to excess emissions will drive down the costs of the mechanism and minimise instances of non-compliance.

In relation to limits on deferral, it will be important this is designed so that any deferral of compliance does not result in delayed or perverse investment decisions in the NEM – especially as the Guarantee is meant to provide clear investment signals for new generation. Retailers should only be able to defer a limited portion of their emissions obligation each compliance year so that investment can be made in the right place at the right time. Unlimited deferral could also impact the trajectory for meeting the NEM-wide emissions target which could result in significant costs in the later years.

Use of offsets

The Business Council has consistently supported emissions reduction policies that allow access to credible domestic and international permits to ensure compliance can be managed at least-cost. In particular, access to credible, high-quality international permits as a means for businesses to acquit their emissions liability at least-cost must be considered as part of the development of long-term, whole-of-economy emissions reduction strategy.

The Commonwealth Government is considering whether retailers should be permitted to use offsets external to the electricity sector as a flexible compliance option to meet the emissions requirement under the Guarantee. If permitted, the ESB will determine the rules and limits of their use.

The Business Council supports the availability of external offsets – both domestic offsets such as Australian Carbon Credit Units (ACCUs) and international permits – being considered throughout the design of the Guarantee. If offsets are to be permitted in other sectors of the economy then it is important that they are also considered when designing the emissions requirement of the Guarantee.

However, unlike an economy-wide emissions reduction policy, the Guarantee only serves to reduce emissions in the electricity sector. As such, allowing offsets – particularly international units of which very little detail is often known – could undercut abatement efforts in the NEM.

Further, the Guarantee is not only an emissions reduction mechanism but also a mechanism that serves to encourage investment in new generation. As a result, allowing the use of offsets from outside the electricity sector could undermine investment decisions in the NEM. This is of greater concern in the case of international permits of which there is not a lot of information about price and availability of credible, high-quality units. In contrast, domestic offsets, such as ACCUs, are better understood and a legal framework already exists for their exchange. That said, uncertainty around international permits is largely due to international market rules for the post-2020 period still being negotiated under the Paris Agreement. It is expected that once these rules have been finalised there will be greater certainty and information about credible international permits and therefore their future use – alongside domestic units – should not be ruled out. These issues should be taken into consideration when deciding whether to allow the use of offsets to meet the emissions requirement.

The overarching purpose of the Guarantee is to ‘provide a clear investment signal so the cleanest, cheapest and most reliable generation gets built at the right place at the right time.’[7] The design of the compliance regime under the emissions requirement cannot be allowed to undermine this. Indeed, there is trade-off between meeting the requirement and maximising compliance flexibility. A balance must be struck between flexibility and least-cost options for

[7] ibid.

compliance and achieving the primary objective of the mechanism – providing a long-term investment signal in the NEM that will ensure a reliable system and put downward pressure on prices.

If offsets are permitted to be used for compliance, the possibility of limitations should be considered.

RELIABILITY REQUIREMENT

Designing the reliability requirement

The Business Council supports placing a reliability requirement on retailers to create an incentive to invest in dispatchable generation. The reliability and security of our energy system must be prioritised as we transition to a lower-emissions future.

However, the Business Council urges the ESB to adopt a minimalist approach to market intervention in designing the reliability obligation. One of the main goals of the Guarantee is to put downward pressure on prices but an intrusive and complex reliability obligation threatens imposing significant costs on retailers and other market participants that will ultimately flow through to consumers.

Therefore, the reliability requirement must be designed as a light-handed mechanism designed to send a clear investment signal for dispatchable resources in the NEM, and only crystallise into an obligation on retailers as a last resort if a significant reliability gap is identified.

The costs associated with an intrusive, complex and burdensome mechanism are likely to be significant. Stakeholders have warned against an obligation that effectively results in a 'gold-plated' energy market for reliability. This will only result in higher electricity prices – as demonstrated by the 'gold-plating' of the network.

Forecasting

Under the ESB's proposed design of the reliability requirement, forecasting whether there will be any reliability 'gap' in a certain region at a particular point in time will be the first in a series of steps. This forecast will then be regularly updated as the market changes. At a certain point in time, the forecast reliability gap will trigger the reliability requirement and retailers will be required to respond.

It is vital that forecasts incorporate all available data and information to ensure projections are as accurate as possible. Transparency of forecast inputs, assumptions and methodology is critical as investment decisions will be underpinned by these projections. While existing forecast processes currently exist, such as the Medium-Term Projected Assessment of System Adequacy (MTPASA) and the Electricity Statement of Opportunities (ESoO), these projections do not currently impose an obligation or compliance burden on market participants. Under the proposed reliability requirement, however, a forecasted reliability 'gap' will crystallise into a regulatory obligation on market participants – this will come with associated costs and liabilities. Therefore, retailers must have confidence and input into the forecasting process.

The costs of an over-projected reliability gap will be significant and risk a 'gold-plated' energy market for reliability. Retailers will bear the risk of inaccurate forecasts, with costs eventually passed on to consumers. A robust and consultative forecasting process will help mitigate some of this risk.

Qualifying instruments

The Business Council stresses the importance of maintaining liquidity in the electricity contract market. The *Independent Review into the Future of the National Electricity Market* highlighted that 'Electricity markets need sufficient liquidity to operate effectively,' while the ACCC's inquiry into retail electricity prices underscores the importance of liquid wholesale contract markets putting downward pressure on prices.[8]

The purpose of the Guarantee is to deliver a more reliable and affordable energy system while transitioning to a lower emissions future. This can only be achieved if the liquidity of the financial contract market is preserved, which in turn will promote competition in the market.

Creating new 'qualifying instruments' or requiring contracts to be 'physically backed' in order to meet the reliability requirement under the Guarantee will result in less fungible products and reduce the liquidity of the financial market. This will affect investment decisions and contribute to the volatility of wholesale prices.

Therefore, the Business Council supports the use of existing financial contracts such as exchange-traded and over-the-counter (OTC) contracts, including caps and swaps, qualifying for meeting the reliability requirement. Caps and swaps must be able to qualify as 'eligible contracts' under the requirement without the need to demonstrate 'physical backing.' If the reliability requirement can be met by these existing financial instruments then it is likely the fungibility and depth of the market can be preserved.

Allocating the requirement

Expressing the requirement as a total or increment

The Business Council supports allocating the reliability gap as a 'shortfall.' This approach will provide more flexibility to retailers when managing their load, determining hedge contract positions and degree of exposure to the spot market. Imposing a 'total' obligation would suggest that retailers need to fully contract their load to meet the requirement. This would limit a retailer's ability to determine their own contractual strategy.

Large energy users

The Business Council supports applying the reliability requirement to large energy users registered as Customers under the National Electricity Rules (the Rules). These large users currently participate directly in the wholesale market and are therefore experienced in managing their contract positions. That said, the administrative burden of complying with the requirement would need to be considered.

The consultation paper also suggests extending the reliability requirement to large commercial and industrial (C&I) customers that are not Customers under the Rules, but rather use a retailer as an intermediary. This proposal would significantly change the risk profile of large C&I users that currently use a retailer as an intermediary to manage this very risk. At this stage in the design process it is not evident that extending the requirement to large C&I customers – a definition that requires further clarification – would materially assist in achieving the objectives of the Guarantee. Any further consideration of this extension must take into account the potentially onerous compliance and administrative burden such a change would put on large C&I users.

8. Dr Alan Finkel AO, *Independent Review into the Future of the National Electricity Market,* June 2017; ACCC, *Retail Electricity Pricing Inquiry: Preliminary report,* September 2017.

Procurer of last resort

One of the final steps of the proposed design of the reliability requirement is to have the Australian Energy Market Operator (AEMO) perform the function of ‘procurer of last resort’ if retailers have not met their reliability obligation by a specified compliance date.

The ESB must consider the design of the procurement of last resort mechanism under the Guarantee alongside the development of ongoing reliability work emerging from the Finkel Review, such as the need for a strategic reserve and the role of the existing Reliability and Emergency Reserve Trader (RERT).

Recent reports suggest that there were incredibly high costs associated with activating the RERT over the 2017-18 summer – costs that will ultimately be passed on to business and households. Therefore, AEMO acting as a procurer of last resort under the Guarantee must only occur actually as a ‘last-resort’ to meet the reliability requirement as it is likely to come with significant costs and reduce the ability of the Guarantee putting downward pressure on prices.

The ESB also needs to consider how to manage a perverse incentive developing under the reliability requirement in which generators opt to wait for AEMO to step in as the procurer of last resort as it is likely to be more beneficial financially than contracting with a retailer earlier in the forecast timeline.

GOVERNANCE

The Business Council supports the implementation of the Guarantee through existing governance arrangements in the NEM, following the agreement of COAG Energy Council.

Embedding the Guarantee in the Australian Energy Market Agreement (AEMA), the National Electricity Law (NEL) and the Rules means that changes could only be made with the agreement of COAG Energy Council.

Such an approach ensures certainty, stability and confidence in the enduring operation of the policy as it is removed from the vagaries of politics and requires widespread agreement to be changed or amended.

Therefore, if agreed to by COAG Energy Council, the Guarantee will be entrenched in the broader energy governance framework so that it can provide the clear, long-term investment signals required to achieve reliability and affordability in the NEM as Australia transitions to lower-emissions energy system.

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