

# SUBMISSION

UNDERWRITING NEW GENERATION INVESTMENTS  
9 NOVEMBER 2018



Energy Division – Underwriting New Generation Investment  
Department of Environment and Energy  
Canberra

Via Email: [UnderwritingNewGenerationInvestment.gov.au](mailto:UnderwritingNewGenerationInvestment.gov.au)

9 November 2018

## INTRODUCTION

The Energy Users Association of Australia (EUAA) is the peak body representing Australian commercial and industrial energy users. Our membership covers a broad cross section of the Australian economy including significant retail, manufacturing and materials processing industries. Combined our members employ over 1 million Australians, pay billions in energy bills every year and are desperate to see all parts of the energy supply chain making their contribution to the National Electricity Objective.

Our members are highly exposed to movements in both gas and electricity prices and have been under increasing stress due to escalating energy costs. These increased costs are either absorbed by the business, making it more difficult to maintain existing levels of employment or passed through to consumers in the form of increases in the prices paid for many everyday items.

It is clear that energy markets have been in transition for the last decade and this is set to continue, at pace, for at least another decade. While managing climate change risk from a social, environmental and economic perspective is undoubtedly one driver of this transition, so too are changes in the structure of energy markets and the nature of its participants along with the inevitable retirement of legacy fossil fuel assets. We observe that, to date, this transition has been dogged by the chaos of policy inconsistency, fundamental differences between state and federal jurisdictions and unhelpful public debate. This has led to increased risk for all investors and higher costs than necessary for consumers.

In the absence of national, bipartisan energy policy that provides investors and energy users with sufficient comfort to enter into long-term agreements it may be necessary for a level of intervention as outlined in Recommendation 4 of the ACCC Retail Electricity Pricing Inquiry. Under the circumstances and in the absence of short to medium term alternatives to drive investment in new generation, the EUAA are supportive of the concept of Recommendation 4, provided robust, transparent processes are in place that ensure these investments are made at the right time, for the right reasons and are in the long-term interests of consumers.

We would note that this approach is not without potential issues. As we have stated in our media release on 12 July 2018 “ The proposal to provide government backed contracts for new generation in certain circumstances has some attraction..... However, the EUAA would need to understand the potential ramifications, both positive and negative, of such actions by governments, particularly the effect these proposals may have on long-term investor confidence.”

We would encourage government to be cognisant of this and develop policy in this area accordingly.

## EUAA RESPONSE TO OPTIOINS

As a general comment on government intervening in the energy market in ways that are being contemplated. A number of EUAA members have expressed a concern that non-government investors may be less inclined to invest in new generation assets if they are competing against government capital in the same area. They are concerned that it has the potential to distort the market and, like any government program, could be open to gaming by investors and project proponents.

Therefore, if government where to invest it must be on the basis that it is stepping in where there is both a clearly identified need (i.e. demonstrated shortfall of supply) and a clear absence of private investment. Above all, the process must be robust and transparent to avoid opportunities of project proponents to manipulate the process to the detriment of energy consumers.

As an example. One of the criticisms of recent renewable energy auctions and the awarding of contracts (CFD) to project proponents has been the lack of transparency of the CFD strike price and contract volume. It is our view that if project proponents are receiving significant benefit from taxpayers or energy users via direct contract support or subsidy then this component must be made public and not protected under commercial confidentiality.

While we are supportive of governments efforts to encourage investment, it is a clear preference of the EUAA that market mechanisms are primarily used to drive investment in new generation and that governments, rather than being the primary driver of this investment, should seek to play a supporting role to lower risk and costs of participation. The mechanisms proposed in the consultation paper could be developed to achieve this objective.

The EUAA provide the following comments on the options provided in the consultation paper. We believe that, if properly designed and thoughtfully implemented, each option has merit and have the potential to achieve the stated objectives as part of a broader market reform package. However, more precise detail is required before the EUAA and its members can agree on our preferred option, if at all. Therefore, our comments largely focus on the main pros and cons of each option.

MECHANISMS FOR ATTRACTING INVESTMENT	EUAA COMMENTS
ACCC Recommendation 4 – Providing a floor price	<ul style="list-style-type: none"> <li>• Would provide a level of investment support while also encouraging a response from the market in the first instance (i.e. requiring minimum contract volume). Pre-signing a number of customers ensures that the project has passed a form of “market test” first, before government provides additional support.</li> <li>• Through increasing supply (and capacity), this mechanism would help put downward pressure on prices and improve system security in the region in which the project is built.</li> <li>• Unlike the RET, where mechanism costs are recovered from energy users (negating some of the wholesale benefit of additional supply) the mechanism cost would be a cost on the federal budget.</li> <li>• While price and contract term have been identified (\$45-\$50MWh &amp; 6 to 9 years), MWh contract volume or total MWh volume of the program needs to be understood as this is fundamental to the total cost of the program. In particular, will there be a MWh cap to the program and therefore a cap on costs?</li> <li>• Transparency of selection criteria and process is fundamental. If multiple projects are seeking to gain access to this mechanism, will</li> </ul>

	<p>there be a reverse auction style process and will the results be transparent?</p>
Contract for difference (CFD)	<ul style="list-style-type: none"> <li>• CFD's are a well-known mechanism, commonly used in Australia to encourage renewable energy and could easily be used more broadly.</li> <li>• Unlike the RET, where mechanism costs are recovered from energy users (negating some of the wholesale benefit of additional supply) the mechanism cost would be a cost on the federal budget.</li> <li>• In conjunction with a reverse auction style approach to project selection, it can provide the lowest cost generation and has a strong link to the market via the strike price.</li> <li>• Strike price of the CFD is the key to managing government/taxpayer costs and risk. Given the volatility of market prices and policy environment, CFD's are not without downside risk for government. For example, state policy to drive investment in generation (rooftop PV for example) could put significant downward pressure on regional prices, driving it lower than the strike price and placing a payment obligation on government that was not anticipated.</li> <li>• Consideration should be given to a "strike price reset range" or "mark to market" clause where changes to market conditions can be considered and strike price re-set, say every 5 years. (See also our comments on cap and floor contracts).</li> <li>• As with ACCC Recommendation 4, we need to understand the total volume boundary of the mechanism to understand total costs and risks of this approach.</li> </ul>
Cap and floor (Collar) contracts	<ul style="list-style-type: none"> <li>• As the consultation paper states, this is similar to the CFD option but contains up-side and down-side risks for participants and governments.</li> <li>• This option could feature as part of a hybrid approach to manage risks of a CFD approach. For example, it could form the basis of a "strike price reset range" or boundaries for a "mark to market" approach.</li> </ul>
Government loans	<ul style="list-style-type: none"> <li>• Already a feature of the renewable energy industry via the Clean Energy Finance Corporation (CEFC).</li> <li>• The CEFC could be extended to include projects being supported by the chosen mechanism and would work to reduce project costs, flowing through to cheaper energy costs and a lower strike price or price floor.</li> <li>• To broaden the type of generation eligible for assistance, a change to the CEFC mandate would be required. If not, then a new funding source would need to be established. If this is the case then we strongly recommend that many of the investment principles and rigor of the CEFC be adopted to ensure commercially sensible projects that provide a market-based return on capital are supported.</li> </ul>
Capacity payments	<ul style="list-style-type: none"> <li>• Capacity payments, via an open and transparent capacity market, are used in other jurisdictions around the world.</li> <li>• In Australia, the Reserve Trader Mechanism (RERT) provides a form of capacity or availability payment to large loads. This is being used as a mechanism of last resort and we do not support it becoming a permanent feature of the NEM.</li> </ul>

	<ul style="list-style-type: none"> <li>• Capacity payments allocated by governments or regulators is not a preferred approach (even via a reverse auction approach).</li> <li>• A market-based approach to building capacity that was anticipated to evolve from the Reliability Guarantee, would be a preferred approach if this was the desire of government.</li> <li>• Regardless of the approach, capacity markets will by necessity drive investment and incur costs associated with creating a situation of “over capacity” and, at times, underutilised investment. As such, some may see this as an inefficient allocation of capital.</li> </ul>
--	------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

## HYBRID APPROACH

Rather than a “picking winners” approach to project selection, a hybrid approach could be considered that is guided by the objective of exposing as many of the elements to competition and open markets as possible, therefore making the mechanism as cost effective as possible for consumers while also reducing the cost and risk to government/taxpayers.

A hybrid approach that is highly linked to energy markets, or that rely on investment signals based on market dynamics, would also assist in the timing, volume and location of new generation investments. This would help avoid inappropriate investments being made in new generation that are based on an arbitrary assessment or other factors that are not driven by market signals and that many not be in the long-term interests of consumers.

The Reliability Guarantee could form the basis of this approach. The EUAA had observed that market participants were in the process of considering new investments, altering strategies and asset operations to compete more effectively under the proposed Reliability Guarantee and we expect this would be re-energised if this approach was re-instated. Importantly, it was anticipated that the Reliability Guarantee would see the emergence of a secondary capacity market where distinct capacity products (including contract, demand response and physical products) would be offered to market participants.

The Reliability Guarantee had a strong link to the energy market and would only be triggered on the basis of robust, independently verified process based on market dynamics such as a clearly identified shortfall of supply. Part of this process included an annual “book build” by AEMO. This book build could continue to be a feature, potentially forming an important part of project discovery and transparency in the early stages.

This could then be supported by a selection of mechanisms described in the consultation paper including:

- On identification of a potential gap in the market (for example at T-3 in the Reliability Guarantee) ACCC Recommendation 4, CFD, Cap and Collar (or a combination of the two in a hybrid approach) could then be used to help underwrite this new investment to meet the AEMO identified shortfall.
- All of these options could still require a minimum level of customer contracts to be obtained first by the project proponent as set out in ACCC Recommendation 4. The AEMO book build could play an important role is attracting these customers to projects in the first instance.
- In this way, the mechanisms set out in the consultation paper assist the Reliability Guarantee, as a market-based approach by supporting specific new build of firming capacity.
- Government loans to provide further support and reduce costs.

A hybrid approach such as the above would rely more on market forces to identify the need and deliver the desired outcomes of government while supporting the type of investment required to meet price and system strength objectives. It would also provide some boundaries to costs and risk.

Specific capacity payments could be offered as part of a hybrid approach, however with an identified need and secondary market in capacity emerging as part of the Reliability Guarantee, such an approach is unlikely to be required.

## **FORCED DIVESTITURE**

We are aware that the federal government is contemplating developing a policy of forcing divestment of energy assets under specific circumstances. While the intent of this, to reduce market power of some participants, may have a basis in ACCC Recommendations 1, we do not believe that forcing market participants to sell assets that they have legally acquired and are being operated within the law and regulation, is a sound approach.

If a policy of forced divestiture was to be adopted, we believe it would represent significant and genuine sovereign risk and have profound negative impacts on the investment environment. The EUAA would not support such an approach.

## **CONCLUDING COMMENTS**

We appreciate the intent of the federal government and the discussion paper to drive new investment in generation capacity which would improve system security and lower wholesale costs. Clearly these are worthwhile objectives and are wholeheartedly supported by the EUAA. These are the same reasons for our support of the National Energy Guarantee as it was aimed at achieving these same outcomes.

We are also supportive of the mechanism objectives of helping to resolve the energy trilemma, including managing climate change risk. This aligns with the objectives and risk management approach of market participants and would further help lower overall costs.

At this point in time, the EUAA are not in a position to provide government with a preferred approach and would require more information before this could be so. In this regard, the EUAA would welcome further interaction with the federal government as it develops the options outlined in the discussion paper.



Andrew Richards

CEO

9 November, 2018