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Energy Division – Underwriting New Generation Investment Submission

Department of Environment and Energy

GPO Box 787

Canberra ACT 2601

15 November 2018

Dear Sir / Madam,

Underwriting New Generation Investment

AGL Energy (AGL) welcomes the opportunity to comment on the Department of Environment and Energy's Underwriting New Generation Investment consultation paper (Consultation Paper).

The market is experiencing a challenging investment environment, exacerbated by disincentives for longer contracting by larger commercial and industrial (C&I) customers. These are significant drivers behind the tightening supply in the National Electricity Market and higher wholesale prices. AGL considers these issues need to be addressed and supports the consideration of mechanisms to improve investment signals for generation capacity. The proposal in the Consultation Paper raises some risks, and we are more broadly concerned with the number of different mechanisms being considered by different market bodies.

Unintended impacts of mechanisms under consideration

At present, mechanisms that seek to address increasing the reliability and dispatchability of generation and/or liquidity of financial products within the NEM include the Reliability Obligation, Market Making mechanisms for South Australia and the Enhanced Reliability and Emergency Reserve Trader mechanism. These are being progressed through different market bodies, such as the Australian Energy Market Commission, the Energy Security Board and at Federal and State Government level. It is unclear if there has been adequate consideration of how these mechanisms would interact and whether they would achieve the requisite outcomes in an efficient manner that has the least cost for end use consumers.

Regarding the specific proposal for underwriting new generation investment we have more specific concerns. As stated, AGL is very supportive of appropriate incentives for the longer contracting terms between generators and larger customers sought under this mechanism. However, if this is the key goal, we would strongly support a broader consideration of the problem and which mechanisms, including the proposed mechanism, would have appropriate interoperability and would be more efficient and cost effective in addressing the specific problem. We are concerned that this is yet another market intervention that may not actually address the current issues seen by customers. In fact, such a mechanism could further inhibit market signals for investment.

A key issue posed by the proposed mechanism is that the various options put forward in the consultation paper are highly likely to distort market signals even further and discourage non-subsidised private investment entirely. The mechanism would likely only allow government supported generation to be competitive and could thus push existing generation out of the market earlier than otherwise expected.

Depending on the other mechanisms being developed, this could potentially create perverse outcomes where generation required to meet reliability obligations or needed for firming, would not be able to compete against subsidised new-build generation and would then require its own subsidies to remain in the market.

As an additional issue that was also raised during development of the National Energy Guarantee, there continues to exist a first-mover disadvantage for large customers that participate in such mechanisms. That is, where the mechanism is designed to reduce wholesale prices by increasing firm supply, the customer(s) that contract with a new-build generator at a set price for a period of 5 years are likely to then see their competitors receive the benefit of the lower wholesale prices that result from increased supply with none of the risk that is created through such long-term contracting.

Consideration of Recommendation 4 of the Retail Electricity Pricing Inquiry

Having reviewed the Retail Electricity Pricing Inquiry as the initiator of this current consultation we consider the following elements need further review.

The REPI report states:

"Where private sector banks are unwilling to finance projects due to uncertainty about the future of an industrial or manufacturing business, the ACCC considers there is a role for the Australian Government in providing support for such projects in appropriate circumstances. This can be achieved at little cost to government. Specifically, the ACCC proposes the government introduce a program under which it will guarantee offtake from a new generation asset (or group of assets) in the later years of the project (say years 6–10 or 6–15) at a low fixed price sufficient to enable the project to meet financing requirements."

The consultation paper deviates from this original proposal, by suggesting additional for consideration. We note that the original recommendation would only have government support being provided after the first five year period under which foundation C&I customers have signed. In the proposed mechanism, the floor and CFD options are explicitly stated to kick in after the five years, however it's unclear how the "government loan" and "capacity payment" parts would work in this context. Are they intended to also be limited to the period following the initial five years or would they effectively apply to the whole investment? It is unclear as to whether the other options are to be implemented in a manner that has the same effect as the floor and CFD options by de-risking the latter period of the investment.

Additionally, the intention of the floor price recommended by the ACCC was to remove the tail risk in the investment, by being set deliberately low so the generator would still be incentivised to contract after the five year period. It is not clear if the other mechanisms have this same incentive intended to be incorporated. That is each of the mechanisms should provide the same incentive to the generator to contract after the five year period and not simply rely on ongoing subsidies.

The REPI report also states that:

"Despite this trend, the ACCC has received confidential feedback from a number of market participants (project developers, smaller retailers and large industrial or manufacturing customers) who have indicated that they are constrained in their ability to support new investment. These participants cited an inability of certain customers to commit to a long-term contract (PPAs are usually in the order of 10 years) or insufficient credit-worthiness as the main reasons why they have been unable to finance projects."

We would suggest that consideration could be given to the government providing some form of credit wrap of the customer where counterparty credit worthiness is an issue for the project developer.

Eligibility Criteria

If the main problem to be resolved by the mechanism relates to encouraging longer term contracting by C&I customers, to drive more supply into the market, all projects should be eligible for consideration. When assessing each of the various projects that may be proposed under this mechanism, then issues of market share should be considering in the analysis of the merits of that project.

In addition, there are several possible PPA arrangements available to C&I customers/buying groups and most necessarily involve a retailer (unless the customer is NEM registered or the generator is behind the meter). The criteria should not be so restrictive as to reduce the options available to customers. It might be beneficial to, and desired by, the customer to have its retailer enter into the PPA, or take a novation of the PPA - the option of supporting generation development should equally be available to customers who do not necessarily have the capability or appetite to negotiate or manage a PPA directly. The criteria should therefore be broad enough to allow flexible arrangements to be contemplated.

Another area that may be problematic is the requirement for C&I contracting to rely entirely upon the new generation that is linked to the contract. This is much riskier than allowing such customers to be contracted across a portfolio of assets. We would seek further clarity around how this would work for generators that are seeking to invest in, or add to, a generation portfolio.

Conclusion

The aims of supporting new investment in the market and incentivising a higher level of contracting by C&I customers are strongly supported by AGL. However, we consider that it is imperative that the market is underpinned by economics determining the appropriate level of investment, rather than through desired policy outcomes being sought through increased interventions or subsidies. Where market failures are identified then we would support the consideration of effective and efficient capacity or firming mechanisms that are fully integrated into the overarching market design.

If you have any queries about this submission, please contact Chris Streets on (03) 8633 6758 or cstreets@agl.com.au.

Yours sincerely,

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