



The National Energy Guarantee

INVESTOR BRIEFING

On February 15, the Energy Security Board released a Consultation Paper for input on the development of the National Energy Guarantee (NEG).

It builds on the high level proposal released in October 2017, setting out a framework to apply an emissions obligation and a reliability obligation to energy retailers.

This briefing provides a short summary of what was announced, things to note, IGCC's response and what is likely to happen next.

WHAT WAS ANNOUNCED?

The ESB has proposed high level options for how the Emissions Requirement and the Reliability Requirement could operate. They are seeking feedback on how the respective requirements are measured, and how compliance with the requirements is demonstrated and enforced.

The consultation paper does not outline a large amount of specific details of how the NEG will operate, but does provide a reasonable indication of how the ESB is likely to approach developing a final design and what is on the table in terms of ongoing policy discussions.

The Consultation Paper is careful to specify which design features are set by the ESB and which are Commonwealth Government policy decisions (namely targets, offset and EITEs).

THE EMISSIONS REQUIREMENT

Under the *emissions requirement*, electricity retailer would be required to measure the emissions intensity of their load and stay below an annual threshold.

The overarching emissions intensity threshold would be set by the Commonwealth Government and the respective abatement task allocated to the electricity sector.

For each compliance year, the emissions target would be expressed in tCO₂-e per MWh with reference to its load and the emissions associated with contracted and uncontracted purchases. This will be calculated annually. NGERs data would be used to calculate emissions.

A default emissions intensity would apply to uncontracted electricity purchased via the National Electricity Market.

The annual calculation of emissions per MWh would also be adjusted for over and under achievement against compliance from the previous year (called a 'carryover adjustment factor') and incorporation of any voluntary 'green' programs.

The ESB has also proposed exempting Emissions Intensive Trade Exposed industries (EITEs), in line with previous exemptions provided under the Carbon Price Mechanism and the Renewable Energy Target.

The ESB sets out a number of flexible compliance mechanisms, including carrying forward credits for overachievement, deferral of compliance



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(allowing retailers to offset excess some portion of their emissions in future years) and the use of offsets (ACCUs and international equivalents).

Compliance options include a range of different enforcement mechanisms, ranging from encouraging a 'culture of compliance' to administrative undertakings, infringement notices, enforceable undertakings, civil proceedings and suspension or revoking authorisation (measures of absolute last resort).

From a governance perspective, the Australian Energy Regulator (AER) would be responsible for administration of the emissions requirement, with input from AEMO and the CER.

The emissions requirement would be implemented in 2020.

THE RELIABILITY REQUIREMENT

The second component of the National Energy Guarantee is the *reliability requirement*, aimed at ensuring sufficient generation capacity is available in the National Energy Market to ensure reliable and secure supply. The overarching goal is to incentivise, ahead of time, sufficient investment to avoid supply shortfalls in times of peak demand through a mixture of analysis and forecasting, reliability obligations on retailers to fill any identified gaps and penalties for failure to deliver. AEMO would act as procurer of last resort.

The ESB is proposing an eight-step process for ensuring reliable supply with different design options at each step.

1. **Forecast the reliability gap:** AEMO forecasts whether the reliability standard is likely to be met across the NEM.
2. **Update the reliability gap:** AEMO updates the forecast over time, adjusting for significant market changes.
3. **Triggering the requirement:** where a gap is identified the ESB anticipates the market would react. If it fails to act sufficiently a reliability gap would be 'triggered' and retailers expected to respond.
4. **Qualifying instruments:** retailers would be incentivised to make investments to plug the gap or enter into eligible contracts to cover their share of the peak demand requirement at the time of the reliability gap.
5. **Allocating the requirement:** if the obligation is triggered, there would be a defined process for filling or allocating the gap to retailers.
6. **Compliance:** The AER would determine whether retailers have met compliance obligations.
7. **Procurer of last resort:** if retailers fail to meet the requirement by the compliance date, AEMO would procure resources to fill any remaining gap.
8. **Penalties:** Penalties would be assigned to retailers that fall short of their reliability requirement.

The ESB has given consideration to the degree to which arrangements to maintain the reliability of the electricity system must be backed up with physical assets and whether financial contracts may be sufficient to provide sufficient security of supply.



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The ESB is looking to provide flexibility in how the market provides adequate guarantees of supply and cost protection. The most direct response would be to require retailers to commission new dispatchable generation capacity when a capacity shortfall has been identified by AEMO

Certain types of financial contracts such as exchange traded and OTC contracts (swaps and caps) are also considered, This is reasonably reflective of current market practice and potentially a means of promoting greater liquidity and protecting against wholesale price fluctuations.

The ESB has proposed a supply forecasting mechanism, requiring AEMO to provide a forecast of supply adequacy into the future (proposing a 10-year forecast), to identify any potential capacity shortfalls. This would build upon forecasts AEMO already completes as part of the NEM Electricity Statement of Opportunities.

Capacity adequacy forecasts would allow the market to respond to identified shortfalls, with the “trigger” mechanism to mandate that action is taken by market participants to ensure supply with a minimum period of notice (proposing 3-years).

AEMO may also act as a “procurer of last resort” if insufficient action is taken to guarantee supply to the market. The costs of such actions would be passed on to market participants.

Again, the ESB as proposed that the AER be primarily responsible for the

administration of the reliability component, working closely with AEMO.

THINGS TO NOTE

In reviewing the operation of the NEG as a whole, there are a number of further interesting points to note about the proposed design.

Level of emission ambition: The ESB does not make any recommendations on the of emissions reduction ambition, and the contribution of the electricity sector towards emissions reduction goals and is not expected to make any.

The Consultation Paper devotes an entirely separate chapter to Commonwealth Government Design Elements, including emission targets, offsets and EITs.

The paper has been developed on the assumption that the Commonwealth Government will maintain a -26% emissions reduction target to 2030, with the electricity sector making a proportional reduction (achieving a -26% reduction from electricity emissions).

The Commonwealth would initially set an electricity emissions target trajectory for ten years from 2021 to 2030.

The NEG then builds on the approach set out in the Government’s 2017 Climate Change Policy review that targets would be set every five years for the next five years out past 2030. For example, the 2035 NEG target would be set in the context of the 2025 national emissions target under the Paris Agreement and locked in.



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The ESB is seeking feedback on potential mechanisms for setting annual targets, including whether there should be rolling annual targets, set at least five-years ahead. Otherwise it leaves the national policy commitments (and question of their efficacy) to the Commonwealth.

This makes it challenging as a key consideration in assessing the impact of the scheme of the whole is its ability to deliver scalable and credible emissions reductions targets.

EITIEs exemptions and implications:

The ESB has also proposed exemptions for Emissions Intensive Trade Exposed industries for the emissions obligation, in line with previous exemptions provided under the Carbon Price Mechanism and the Renewable Energy Target.

This raises a question of whether such exemptions are necessary, as the cost implications of the emissions requirement may be negligible compared to the other schemes.

Depending on the final design of the emissions requirement, and the contractual arrangement that retailers undertake, there may be the potential for perverse outcomes for EITIEs if they are to seek PPAs outside of a NEG mechanism.

Treatment of the States The consultation paper has flagged that actions undertaken under State and Territory schemes will not be considered as being in addition to the Federal targets. This will be a controversial point, as some States have developed policies that are intended

explicitly to provide additionality to Federal policy.

In relation to both the emissions guarantee and the reliability guarantee, the ESB is also asking for feedback on the treatment of Tasmania and the ACT, as two jurisdictions with significantly different arrangements and market structures to the other NEM States. The question of how Western Australia and the Northern Territory will be covered currently remains outside of this consultation process.

What about the rest of the economy?

To achieve the current national emissions reduction target set by the Federal Government, additional measures will need to be undertaken in parts of the economy outside of the electricity sector. The NEG is focused specifically on the National Electricity Market, and will not extend to other industry sectors such as agriculture or non-electricity energy use such as industrial processes and transport.

The question of how the remainder of the abatement task will be achieved remains. Emissions reductions are generally more cost effective for the electricity sector. By regulating a lower abatement challenge for electricity, the abatement task and associated costs is increased for other industry sectors. This has implications both for those industry sectors impacted and for the economy as a whole.

GOVERNANCE AND OVERSIGHT

Primary responsibility for administering the emissions obligation and the reliability obligation will reside with the



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Australian Energy Regulator (AER), building upon the existing regulatory role the AER has for electricity retailers.

This will still require the Clean Energy Regulator (responsible for collecting emissions and energy data and the administration of domestic offsets, or ACCUs) and AEMO (operating the NEM and forecasting future capacity requirements/shortfalls) to work alongside the AER to provide necessary data for managing compliance.

Implementation of the National Energy Guarantee will require approval of each of the NEM States and Territories, which will be sought via the COAG Energy Council. Upon this approval, relevant arrangements to the Australian Energy Market Agreement and the National Energy Law (a piece of South Australian legislation mirrored in other jurisdictions) will need to be made.

The AEMC would be tasked with overseeing necessary changes to the National Electricity Rules. Likewise, some amendments to Commonwealth Legislation, particularly relating to the roles of the AER and the CER, would be required.

IN SUMMARY...

It's a complicated scheme, but one which seeks to build on and draw together bits of the existing electricity market and lessons learned from previous emissions trading schemes.

A number of key questions remain. These include:

- The cumulative administrative cost burden of the scheme (for participants and for households) and implications for market competitiveness.
- The ability of the scheme to support or undermine a credible greenhouse gas emissions abatement challenge – and scale it up over time.
- Implications for renewable energy investment (and carbon intensive energy generation) and large energy users remain as yet unclear.
- Capacity to bring together State and Territory energy policies and build political support for implementation under COAG.
- The role of the NEG within the suite of broader Australian climate change policies.

For investors, further work will need to be done to pick through and unpick the various proposed scheme design elements to look at the industry sector, economy wide and climate impacts of the scheme as a whole.

WHAT HAPPENS NEXT?

Submissions on the consultation paper are due by 8 March 2018. The IGCC will prepare a submission and can support IGCC members to draft their own.

The ESB will then provide a draft design paper to the COAG Energy Council in early April with further detail, ahead of the next face-to-face meeting of COAG Energy Ministers in Late April.

Further design work will be undertaken throughout 2018, with an aim of gaining final sign-off on a design for the NEG by the COAG Energy Council in late 2018.