

FINKEL ON THE FUTURE: AUSTRALIA TO RENEW ITS ENERGY POLICY AND RECHARGE INVESTMENT WITH A CLEAN ENERGY TARGET

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Legal Briefings - By **David Ryan, Partner** and **Robert Merrick, Partner**

High retail prices, a state-wide blackout, and a shift away from coal-fired power - In the wake of these challenges to the security and reliability of energy supply in Australia, COAG Energy Ministers commissioned an independent review of the National Electricity Market led by Chief Scientist, Dr Alan Finkel AO. The final report leaves open some key issues that will potentially impact investors' capital investment decisions.

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BACKGROUND

Australia is in the process of transitioning to a lower emissions economy, but this shift comes with challenges for energy security and reliability. The Independent Review into the Future Security of the National Electricity Market (the **Finkel Review**) was commissioned by the Council of Australian Governments (**COAG**) to address these challenges and provide recommendations for overcoming them. A preliminary report was released in December 2016 and was followed by a consultation period, during which submissions were made. The final Finkel Review was released to COAG today.

PRELIMINARY REPORT

The preliminary report did not contain recommendations, but highlighted key issues that needed to be addressed to ensure the future security of the National Electricity Market (**NEM**), including:

- The 'energy trilemma' of balancing security and reliability, affordability and reduction of emissions.
- Integration of new technologies that could improve reliability and security of supply.
- Transition to a low emissions economy and the achievement of Australia's commitments to the emissions reduction targets under the Paris Agreement.
- Enhanced integration of variable renewable electricity generation and the provision of frequency control services as traditional sources of generation decline.
- Rising costs, in particular rising domestic gas prices that have rendered some gas-fired generators uneconomical.
- A market design that incentivises investment while maintaining security and reliability.

As readers will be aware, climate change has been a policy area that is fraught with danger in Australian politics. Just prior to the release of the preliminary report in December, the Federal Environment Minister Josh Frydenberg announced that the Government would consider an emissions intensity scheme (**EIS**) for the electricity sector. The Minister was then forced to revoke his comments within 36 hours due to internal party pressures.

Since the release of the preliminary report, the Government has maintained its position against an EIS. Attention has instead been focussed on a low emissions target (**LET**) scheme. The Labor Party and the weight of the business community supported an EIS, but have expressed a willingness to back a LET as a “second-best” option in the interests of Australia taking some positive action to tackle climate change.

Labor has said it will support a LET because it is easily “scalable”, meaning the scheme variables could be adjusted in the future (ie. under a Labor Government) to accelerate the emissions outcome and to meet further international targets.

FINKEL REVIEW

The Finkel Review is principally about energy security and is wide-ranging in its scope and recommendations. However, the issue that has been attracting the most attention prior to the release of the Finkel Review has been the possibility of introducing a LET. This client alert focuses on the recommended LET component of the Finkel Review and its potential impact on the electricity generation sector.

The key aspects of the Finkel Review on how to achieve a “low emissions future” for Australia are set out below:

- The Finkel Review concluded that a Clean Energy Target (**CET**), in essence a LET mechanism, will provide the lowest impact on power prices to consumers while achieving the modelled emissions reductions, and was therefore the preferred policy approach.
- A CET would operate in a similar way to the existing RET certificate regime. Eligible low emissions generators will receive certificates for electricity produced, and electricity retailers will then purchase these certificates in order to meet their compliance obligations under the CET.
- A CET is ultimately preferred over an EIS due to ease of implementation, as it can readily be built on the model of the existing Renewable Energy Target (**RET**). It is also because the current high cost of domestic gas makes gas-fired generation an expensive alternative to coal for baseload and intermediate generation. A CET will provide a more gradual exit of coal-fired generation than under an EIS.
- A CET will set a target for the electricity generation sector to reduce carbon emissions by 2030. The Finkel Review noted a reduction of 26 to 28 per cent by 2030 (assessed against 2005 levels) **as a minimum**. This would be consistent with Australia’s general commitments under the Paris Agreement, but many commentators had expected the electricity sector to bear a much larger brunt of Australia’s obligations. Ultimately the reductions target is left for the Government to determine.
- A CET will be technology neutral, unlike the RET which applies only to generation from

renewable sources. Instead, eligibility will be determined by an emissions intensity threshold. The threshold will be a measure of carbon intensity for electricity generation, measured as kgs of carbon per MWh of generation.

- Where the threshold is set will determine what generation technologies qualify as low emissions technologies. A baseline of 700kg/MWh will exclude all current coal-fired generators, but may potentially include them in the future if carbon capture and storage was to become viable. Most gas-fired generators are likely to be eligible. However, the Finkel Review does not recommend a specific emissions intensity threshold. Instead, that decision is left to the Government.
- CET will have an additional dimension to the RET (which allows one certificate to be created for each MWh of eligible generation). The lower the emissions intensity of the generator, the more CET certificates the generator will be entitled to receive.
- Unlike an EIS, generators who are above the emissions intensity threshold will not face a compliance cost. However, they will not be eligible to receive low emissions certificates (and earn the related revenue stream). This will impact the competitiveness of the respective generation technologies in the NEM.
- A CET should continue indefinitely, but there may be a limit on the number of years for which an individual generator is eligible to receive CET credits (the Finkel Review modelled 15 years).
- New generators will also be subject to reliability standards that may require wind and solar plants to install battery storage or arrange the installation of new back up generation (this support cannot be contracted from existing installed capacity). This will increase the cost of developing renewables. Different reliability standards may be set for different NEM regions.
- Large generators will be required to provide 3 years' advance notice of closure, to mitigate security shocks from the exit of large generation capacity.

IMPLICATIONS

- Many of the recommendations of the Finkel Review are broad-scoped and the Finkel Review is not particularly specific on the key details. It is crafted as a set of recommendations to Government, with the Government left to determine the preferred approach and specific policy settings. The response of the Government to the Finkel Review, and the determination of the key settings of any CET, will therefore be key.
- The most political issue is likely to be the threshold. To include “clean coal” technologies, the threshold would need to be no lower than 750kgs/MWh. However, if the CET operates on the basis that the number of CET certificates an eligible generator can create will depend on its emissions intensity, then merely scraping in below the relevant threshold may be a hollow victory.
- The interaction of the RET and a CET scheme will be important. However, the statements regarding the RET in the Finkel Review do not provide a lot of detail. The Finkel Review recommends that the RET should continue in its current form until expiry at the end of 2030 and should not be extended. A CET will be introduced by 2020 and will be a supplemental policy to the RET. The Finkel Review notes that the Government will need to consider how to prevent renewable generators from benefitting under both schemes.
- The Finkel Review notes that new generators would be eligible to create CET certificates for all their generation. However, existing generators would only be eligible to create CET certificate for generation above a baseline (which is not specified).
- The RET has contributed to an increase in renewables and a decline of traditional sources of generation, but wind and solar are not able to provide ancillary services such as frequency control that are typically provided by traditional generators. The Finkel Review places the obligation to address some of these reliability issues on the renewable generators with requirements for battery storage capacity and back up supply arrangements from new build generation. These obligations are likely to be higher in regions with higher levels of renewables capacity.
- Existing power purchase agreements will need to be carefully reviewed to determine the party that will receive the benefit of a CET revenue stream, and how generation after 2030 will be treated. New power purchase agreements will need to consider the likely requirement for battery storage and back up supply arrangements.
- If there is likely to be an impact on the NEM spot price from the introduction of a CET, then hedge contracts will need to be carefully reviewed to determine whether the introduction of a CET constitutes a change in tax/carbon tax for the purpose of ISDA and other electricity hedge structures. If so, it may be necessary for parties to consider dusting off some of the analysis and adjustment mechanisms we saw employed during the previous carbon pollution reduction scheme/carbon tax.
- The key issue for investors will be whether the CET provides the regulatory certainty required to make large and long-term capital investment decisions. While the operation of the NEM under a RET and CET will need to be assessed, and forward NEM pricing projections adjusted accordingly, investors will be influenced by the extent to which a CET, or its component parts such as the threshold, is open to future review or adjustment.
- There are a number of other proposals in the Finkel Review impacting the electricity market that deserve further attention, including the promotion of domestic gas production, the suggestion of an ex ante (day ahead) market in the NEM and limiting the life of coal-fired generating plant to 50 years. These will be the subject of further client alerts.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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