

11 February 2022

Anna Collyer
Chair
Energy Security Board

By email to: info@esb.org.au

Dear Ms Collyer,

RE: Capacity Mechanism Project Initiation Paper

Enel Green Power (EGP) appreciates the opportunity to respond to the Energy Security Board (ESB)'s Capacity Mechanism Project Initiation Paper.

Founded in 2008, and part of Enel Group, EGP builds and operates large scale renewable generation capacity in energy markets around the world. EGP operates in 32 countries across 5 continents with a managed capacity of over 52 GW of renewables and over 1,2000 plants. EGP is the largest privately owned renewable energy company in the world, generating renewable electricity from hydro, solar, wind and geothermal resources across the globe.

EGP has also recently obtained its retail licence and is now actively pursuing retail opportunities in the Australian market.

EGP is broadly supportive of the Clean Energy Council (CEC) submission to this consultation. Our preference is to retain an energy only market with a deep and liquid market in financial contracts for hedging purposes. The case for a capacity market has not been made in our view.

That said, we appreciate the ESB consulting with stakeholders on the detailed capacity market design and its presentation of several straw man models for consideration. While EGP has not finalised its position on a preferred model, our current thinking is to support a decentralised capacity market model, ideally with the incorporation of reliability options.

We set out our views in detail below.

Preferred Model

Of the options presented in the consultation paper we consider Option 1A has the most merit, would leave it to retailers rather than a centralised authority to determine the capacity requirement, based on retailers' forecasts of their customers expected peak demand during at risk periods. Retailers would then be assessed ex-post on whether they procured sufficient capacity to match their actual peak demand, with penalties applying if they did not.

As noted in the consultation paper, retailers are likely to know their customer demand better than a central planner and have strong commercial incentives to get their forecasting right. A central planner could have incentives to over procure, because they do not bear the financial consequences of overcapacity (it is customers that do). Regulatory incentives for central planners are very much geared toward minimising the risk of procuring too little capacity,

understandably perhaps, due to the severe political and economic consequences of the lights going out. However, we consider the risks of under procurement are better addressed through a well specified penalty and compliance framework, rather than building an inherent bias toward excess capacity within the framework.

A further weakness of centrally determining the capacity requirement is that capacity charges become much like network charges, a regulated pass through to customers. There would be no opportunity for retailers to influence these costs, leaving retailers with reduced scope to provide innovative products to their customers.

A decentralised approach would provide retailers with an opportunity to lower their capacity charges, primarily through use of demand response and innovative behind the meter activities that can lower peak demand. Capacity costs then become an opportunity for retailers to innovate and provide differentiated products to customers, rather than just simply being a pass through. In our view a decentralised model will enhance retail competition and increase consumer value.

Another aspect of the fully decentralised approach that is attractive from an industry perspective is that less is mandated through central planning with more of the responsibilities allocated to market participants. For example, the capacity requirement is not determined centrally, but by retailers themselves. The role of a central planner, such as AEMO, would be to provide guidance to the market (through provision of its own forecasts for example) rather than to mandate outcomes or the actions of participants. A decentralised model therefore has the potential to lower regulatory risk and compliance costs for participants compared to a centralised model, however this will depend much on the details.

Decentralised Reliability Options

The ESB envisages a certificate-based scheme for its decentralised model. While this provides a direct link between physical capacity and the retailer obligation, we also note this approach would have significant impacts on the NEM wholesale and financial markets. The wholesale energy price would be unbundled into separate revenues streams for energy and capacity, which would reduce the reliance on spot signals for capacity investment and demand response. Financial contracts such as swaps, caps and options are all referenced against the spot price, which is set to recover both fixed and variable cost of generation. A certificate-based capacity remuneration scheme would fundamentally change the nature of the spot and contract markets.

In this regard we see merit in the concept of a 'reliability options' framework described in the paper. A reliability option would work much like a cap contract specified for a particular delivery year. It is referenced against the underlying spot market and therefore, unlike a certificate-based framework, complements rather than distorts wholesale market signals. A reliability options framework could integrate well into existing spot and contract markets in the NEM, and participants are familiar with how they work (we also note the NSW government is developing its own options type framework to underpin its long-term contracts for generation in renewable energy zones).

The consultation paper considers a reliability options framework for the purposes of a centralised capacity market design. However, we consider it should also be considered an option for a decentralised market design.¹ This would keep the core benefits of the decentralised framework in place (ie. retailers rather than a central agency procure the required

¹ The concept is explored in detail in Poyry, *Decentralised Reliability Options- Securing Energy Markets, 2015*

capacity) but removing the certificates component. Instead, retailers would be obligated to purchase reliability options to meet their peak demand requirements.

We recognise the ESB's concerns with a capacity mechanism based on financial contracts (the indirectness of the link between the financial contract and physical capacity), however reliability options could be designed in a way that removes these concerns. For example, the ability to sell reliability options could be limited to capacity providers (and not financial intermediaries), to ensure they are physically backed. While commercial incentives for delivery should be strong for reliability options (to avoid pay outs on contracts), additional regulatory penalties could be worked into them. There is inherent flexibility in how reliability options might be designed and implemented, while minimising distortions to the energy market.

An ideal application of decentralised options would remove enforced reductions or derating factors for specific technologies (although AEMO could publish these to help inform the market).² If the contract terms of the reliability option, such as duration and penalties for non-compliance with delivery requirements, are well defined up front, then only those parties able to physically deliver on the options will be encouraged to provide them, as to breach contract terms would leave providers open to penalties and lost revenues. There would be no need for enforced reductions in capacity (derating) based on historical performance.

The decentralised options approach would also appear to be more adaptable to technological change compared to a framework that mandates derating factors for specific technologies (such as the WA market). Enforced reduction factors are typically reflected in the number of certificates specific technologies can produce and requires ongoing changes to regulations as technologies evolve. Under a reliability options framework it would be the underlying technologies that would change rather than the options themselves. This approach also better recognises the ability of portfolio approach to back reliability options, again providing greater flexibility to retailers and less administrative overhead compared to an approach that specifically mandates derating factors.

To conclude, we consider a decentralised options approach has significant merit and warrants further consultation with industry. It would provide a framework for meeting policy objectives for greater supply reliability, while leaving much of the decision making on how that reliability is delivered to the decentralised actions of market participants. Compared to more centralised capacity market design options we consider this approach could lower regulatory risk and increase opportunities for innovation and competition, ultimately delivering greater value to consumers.

Please contact Con Van Kemenade, our Head of Regulation, on 0439399943 if you would like to discuss any aspect of this submission further.

Yours Sincerely,



Werther Esposito
Country Manager
Enel Green Power Australia

² Ibid p 27