

29 July 2022

Energy Security Board
Level 15, 60 Castlereagh St
Sydney NSW 2000

via email: info@esb.org.au

Re: Energy Security Board - Capacity Mechanism – High-level Design Paper

The Business Council of Australia (BCA) welcomes the opportunity to respond to the Energy Security Board (ESB) Capacity Mechanism High-level Design Paper.

The BCA supports accelerated action to reduce Australia’s national emissions — this decade and beyond — in order to transition the Australian economy to net zero by 2050 in an orderly and economically prosperous way. Our recent report, *Achieving a net zero economy*, outlines a policy architecture for achieving this.¹

A resilient energy system is crucial to decarbonising the economy

A new national Government reflects the strong community mandate for greater action on climate policy and an accelerated energy system transition in support of a net zero emissions future.

The way our energy sector transitions — in an orderly or disorderly fashion — is absolutely critical to maintaining this strong community mandate for greater action. A failure to appropriately balance energy security, affordability and lower emissions would also be a failure to decarbonise other sectors of the economy in an equitable and economically prosperous way.

It would impact the international competitiveness of Australia’s businesses as users of energy, limit emerging green export opportunities, make it harder to electrify the industrial and transport sectors, compound uncertainty facing regional communities, and diminish households’ ability to absorb the costs of the transition — especially in vulnerable segments of the community.

The current energy crisis is a stark reminder of the vulnerability of our ‘in transition’ energy system to a range of predictable and unpredictable factors. There is ‘no silver bullet’ policy or regulatory mechanism that can make our energy system invulnerable to any and all possible situations, especially where the ‘perfect storm’ of domestic and international conditions presents itself (as happened recently).

¹ https://www.bca.com.au/achieving_a_net_zero_economy

The capacity mechanism is only one of a range of critical reforms required

BCA concurs with the ESB's characterisation of the transition as a "once-in-a-century transformation as Australia moves towards net-zero emissions by 2050". The scale, speed and complexity of the energy system transition cannot be overstated²

- 14 GW of coal-fired generation is likely to retire by 2030, and all coal-fired generation will cease generating by 2043 — or earlier if aging plant performance deteriorates faster than expected
- to replace this coal generation, 122 GW of additional renewables supported by 61 GW of dispatchable capacity will be required by 2050.

After more than two years of research and consultation, the ESB identified four key challenges when creating an energy system that is fit-for-purpose and resilient in the face of this transformation

- being prepared for old coal retirement — maintaining resource adequacy as aging thermal generators exit
- backing up power system security — fixing the security challenges that come with new technologies
- unlocking benefits for consumers — integrating distributed energy resources and flexible demand
- opening the grid to cheaper renewables — keeping pace with the grid access needs of new renewables.

In October 2021 the National Cabinet endorsed the final package of ESB reforms agreed by the Energy National Cabinet Reform Committee. The proposed Capacity Mechanism is an important element in this package, but it is only one of a range of important reforms that needs to be expedited to maximise the resilience of the energy system as it transitions.

Reform of the energy system should be guided by the overarching principle — build a robust and diverse 'new system' before dismantling the 'old system'

The proposed high-level capacity mechanism design

Given the range of views across the membership, the BCA is not in a position to comment in any significant detail on the ESB's high level design proposal for the introduction of a capacity mechanism in the national electricity market (NEM). We offer the following comments

- the assessment criteria used to evaluate different capacity mechanism options needs to include cost and energy affordability — which needs to be considered together with the other criteria
- a capacity mechanism needs to be complemented by well calibrated and coordinated policies to reduce energy sector emissions in line with governments' climate change policy objectives — this will simplify the design requirements and optimisation task of the capacity mechanism
- energy-only market signals remain the primary investment signals in the NEM and as such should not be diluted in light of the introduction of a capacity mechanism — which is designed as a 'back stop' to these investment signals

² AEMO's Step Change scenario estimates (AEMO. Draft 2022 Integrated System Plan).

- a technology agnostic approach is critical to the efficiency and effectiveness of the NEM in delivering on the objectives of energy affordability, security and lower emissions — which applies equally to new mechanisms being introduced (and integrated) into the NEM
- the ‘playing field’ of potential providers of different capacity options is not level with respect to government policy support (especially at the jurisdictional level) — which will impact and potentially distort the mix of capacity being underwritten by a capacity mechanism, unless deliberately adjusted for in the procurement process
- long term regulatory certainty is essential to minimising a capacity mechanism’s costs to households and businesses — the levelized cost of energy resulting from a capital intensive energy project is extremely sensitive to the project’s weighted average cost of capital, which rises with uncertainty
- long term capacity procurement contracts will be needed for new capacity to minimise risk for capacity providers and their financiers — which is necessary to attract investment from a range of sources (private equity and super funds)
- the rules supporting procurement of capacity need to effectively ‘commoditise the service’ being procured so that different technologies with different strengths and weaknesses (for example short and longer term performance) can be evaluated and deployed efficiently
- the amount, location and timing of capacity being procured needs to be linked to any future policies designed to facilitate and manage the orderly closure of aging thermal power stations
- recovering capacity mechanism costs in a way that incentivises retailers to reduce their exposure (for example via demand response measures) has merit — but may also have prudential (credit) security implications which need to be anticipated.

We look forward to the next phase in the development of this very important energy market reform. If you wish to discuss this submission please contact Steven Wright (Director of Energy and Climate Change) on steven.wright@bca.com.au.

Yours sincerely

[signed]

Wend Black
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