



Pollination Capital Partners Pty Ltd
ABN 631 476 956
Level 4, 346 Kent Street
Sydney NSW 2000
+61 2 8313 7109

25 July 2022

Energy Security Board
info@esb.org.au

To Whom It May Concern

SUBMISSION ON THE ESB'S PROPOSED CAPACITY MECHANISM

Pollination is a highly respected climate investment and advisory firm, dedicated to accelerating the transition to a net zero, nature positive future. Launched in Australia 2019, Pollination has a presence in 13 countries across the Americas, EMEA, and the Asia-Pacific. Our climate change and clean energy experts work across the capital value chain to create transition strategies for asset owners, financial institutions and corporates to position our clients and investors for leadership on climate change and nature. We have strong insight into the challenges associated with technology development and clean energy commercialisation for decarbonisation as a consequence of our work across these value chains and lifecycles.

Environmental sustainability should be a core consideration informing the design of energy market reforms.

The National Electricity Objective (NEO), which guides and governs the rule-making activities of the Australian Energy Market Commission (AEMC) as defined in the National Electricity Law (NEL) is:

"to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:

- *price, quality, safety and reliability and security of supply of electricity*
- *the reliability, safety and security of the national electricity system."*

The NEO does not currently include any explicit reference to the need for the energy market rules to promote the environmental sustainability of electricity services or deal with the impacts of climate change on the energy system. The lack of an environmental objective was a result of the thermal generation and political lobby at the time the NEO was last reviewed. As a result, the NEO and the National Electricity Rules (NER) have caused consumers to pay higher costs and generated far higher CO₂ emissions than if environmental externalities (such as CO₂ intensity per MWh) were included in the NEO. The most recent IPCC and IEA reports make it manifestly clear that the cost of inaction on climate change is far higher than the cost of action to address it. Accordingly, in our view it is critical that the NEO be updated to expressly address the connection between the long-term interests of consumers of electricity and:

- the environmental sustainability and carbon intensity of the supply of electricity; and

- the impacts of climate change on the national electricity system.

Embedding these considerations in the NEO will enable market bodies to make rules that better support:

- an orderly and efficient transition to an emissions free energy system; and
- enhanced resilience of the power system to respond to the physical impacts of climate change that are increasingly manifesting in the form of more frequent bushfires, heat waves and floods.

We note that a number of other international jurisdictions have successfully integrated climate or environmental objectives into their energy system regulatory regimes. Pollination therefore recommends that the Energy National Cabinet Reform Committee (ENCRC) consider amendments to the National Electricity Law to reflect the changes to the NEO suggested above.

Any capacity mechanism introduced in the NEM must support the clean energy transition.

Pollination supports the prioritisation of policy mechanisms that enable the reliable, safe and efficient transition from a thermally-dominated electricity generation system to a renewable energy power system.

We do not consider the capacity mechanism proposed by the ESB in its high-level design consultation paper published in June 2022 to be the optimal mechanism for addressing the current challenges facing Australia’s energy market. In particular, we oppose the proposed capacity mechanism on the basis that:

- **The capacity mechanism proposal will put at risk the Australian Government’s commitment to a 43% reduction in CO₂ emissions by 2030.** . The ESB has proposed that all types of generation be included in the capacity mechanism. Any capacity mechanism that provides revenue incentives that would not otherwise occur under the NER and revised NEO (per our submission above) will delay the decarbonisation of Australia’s energy market. The proposed capacity mechanism will favour generation technologies with lower fixed costs and higher operating costs (i.e. thermal power plants), unless the carbon intensity of that generation is included in their marginal cost.
- **If thermal generation is included in the ESB’s capacity mechanism, there should also be a counterbalancing mechanism that facilitates the early closure of such plants in line with Australia’s emissions reduction obligations.** Otherwise, the mechanism will result in beneficiaries of this proposed capacity mechanism remaining in the power system longer than they would otherwise, even if their capacity is not needed. This is likely to deter investment in new renewable generation and storage and thereby hinder the transition that is needed for Australia to achieve its commitments under the Paris Agreement.
- **The proposed mechanism would increase costs to consumers.** The cost of the thermal capacity market in Western Australia has historically been between \$2.9 to \$6.9 billion per year, equating to an average cost per household of \$182-\$430 per year. A “storage” incentive to support high penetration levels of renewable energy would be far more economically efficient. In addition, most capacity payments are likely to provide a windfall to existing generators for remaining operational and available to generate

electricity¹. These generators are already incentivised to behave in this manner through existing market rules and regulations.

- **The proposed mechanism does not enhance certainty around the exit of coal-fired generation from the market.** Commitments from potential investors to develop new renewable energy generation are typically contingent on having a strong understanding of when coal-fired generation is likely to exit the market, given the implications for wholesale electricity prices. The ESB’s proposal will provide a means to extend the participation of coal-fired power plants beyond their efficient technical or commercial lives. As the current market failures of the NEM and its thermal generation fleet shows, the systems needs to be upgraded as soon as possible to clean, 21st century technologies that have higher levels of reliability and marginal operating costs that do not encourage gaming of the energy bidding and dispatch system. .

There are several alternative proposals that would better address the challenges facing the energy market without delaying the clean energy transition. Market participants and stakeholders have put forward a number of proposed solutions to the challenges the ESB is seeking to address through the introduction of the proposed capacity mechanism. These proposals have attracted significantly more support from stakeholders as they offer a cleaner and cheaper energy future for consumers. At a high level, such proposals include:

- A capacity reserve mechanism under which capacity payments would be made only to new, modern, reliable, fast-start, firm capacity such as batteries, hydrogen-ready gas turbines and pumped hydro. These generators would be able to participate in the Reliability and Emergency Reserve Trader (RERT)/operating reserves market, but not in the energy market unless storage or market conditions required them to do so.
- Alternative mechanisms to provide greater certainty around coal plant closures. This may include, for example, strengthening existing regulations around notice of withdrawal from the market or implementing regulated market mechanisms whereby a competitive process determines several years in advance which coal generating capacity will close.
- A strategic investment mechanism under which the government incentivises new investment to meet forecast shortfalls in generation and storage needs.
- An energy storage target to support investment in new utility-scale batteries, hydro and other storage solutions.

Given the above concerns associated with the proposed capacity mechanism as described in the high-level design paper, we urge the ESB to consider alternative approaches to enable an orderly transition of the electricity system that balances cost and reliability with the critical need to decarbonise the National Electricity Market and support Australia’s international climate commitments.

Yours sincerely



Rob Grant

¹ Similar to the “once off” payments made to thermal generation power stations at the time the CPRS was introduced.

CONTACT

Rob Grant

Managing Director
Level 4/346 Kent Street, Sydney NSW 2000

This material has been prepared by Pollination Global Holdings Limited (UK) ('Pollination Group', (or 'we') and is for general information purposes only and is not an offer or solicitation for the purchase or sale of any financial product or service. The material has been prepared for wholesale, institutional and professional clients and is not intended to provide you with financial or tax advice and does not take into account your objectives, financial situation or needs. Although we believe that the material is correct, no warranty of accuracy, reliability or completeness is given, except for liability under statute which cannot be excluded. Please note that past performance may not be indicative of future performance and that no guarantee of performance, the return of capital or a particular rate of return is given. Pollination Group may hold positions in investments described in this material. This material is proprietary to Pollination Group. The recipient of this material agrees not to reproduce or distribute this material in whole or in part and not to disclose any of its contents to any other person.

If you are subject to Australian law, this material is issued by Pollination Capital Partners Pty Limited (ACN 631 476 956) (CAR No. 1282843) ('Pollination Australia') as a corporate authorised representative of Lanterne Fund Services Pty Ltd (AFSL 238198) and TEM Financial Services Pty Ltd (AFSL 430036). Pollination Australia is part of the Pollination Group.

