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NATIONAL ENERGY GUARANTEE DRAFT DESIGN CONSULTATION PAPER

Thank you for the opportunity to make a submission on *the National Energy Guarantee Draft Design Consultation Paper*. This submission is made on behalf of Australia's aluminium industry, and covers the significant electricity use and economic activity associated with aluminium smelters and alumina refineries connected to the National Electricity Market (NEM).

This cover letter outlines our main comments on the consultation paper and the development of "the Guarantee". In the attachment we have provided answers to some of the specific questions posed in the consultation paper, where we have a contribution.

The proposed EITE exemption is critical

The proposal to exempt electricity used to carry out EITE (emissions-intensive and trade-exposed) activities (section 4.3.1 of the consultation paper) will be vital to the ongoing viability of many businesses in Australia.

Recognising that many industrial electricity users have in place long term arrangements, direct exposure to the emissions requirement of the Guarantee - combined with the consistency and reliability of electricity supply required – would significantly increase their electricity costs. Despite recent improvements in technology and reduction in capital costs, renewable electricity sources in Australia are not yet cost competitive when considered on a 'firmed supply' basis.

The trade-exposed element of EITE activities prevents them from recovering these additional costs from the market, leading to reduced profits (perhaps to below zero), reduced expenditure on other items (including sustaining investment), and potential loss of viability.

The threat to industry viability is well understood by those who have worked on energy and climate policy issues and is the basis for an exemption that applies in respect of the Renewable Energy Target, hence the inclusion of the EITE exemption in the Energy Security

Board (ESB) design. The Aluminium Council is strongly supportive of the EITE exemption as a fundamental design element of the Guarantee.

In addition to their importance to regional Australia, large EITE users are important to the electricity grid. It is pertinent to note the increasing frequency – including a number of specific instances in the last 1-2 years – where the stability of the grid in some NEM regions, and the continuity of supply to other electricity users, have only been delivered through the ability of large EITE users of electricity to reduce their demand at key times.

Financial contracts and historical contracts – of certain types – should be accepted as demonstrating reliability

Aluminium smelters and alumina refineries require continuous, reliable electricity supply. Interruptions to supply of more than a few hours cause catastrophic damage to the smelter, requiring either expensive rehabilitation or closure.

Reliability has therefore been an essential component of contracting for electricity supply to smelters for many years prior to it becoming an issue more publicly in the NEM – smelters have been operating in Australia since the 1960s.

The need for reliability, and their high exposure to electricity costs, have led smelters to enter into long-term contractual arrangements. Where the smelter or refinery directly participates in the NEM, these are of the type outlined in the consultation paper – financial hedges such as swaps. Alternative arrangements are only the case where the smelter or refinery does not directly participate in the NEM.

The counter-party to these large long term contracts can only manage their potential price exposure if they have access to firm dependable electricity generation (enabling them to cover their hedged position), and accordingly each of these arrangements is with a counter-party that has significant dispatchable generation.

The financial hedges have ensured the significant quantity of firm generation required to sustain the hedged portion of smelter load is available within respective NEM regions. Financial contracts of this type are necessary to deliver the reliability requirement of the Guarantee – as outlined under the sub-heading ‘Financial contracts’ on page 37 of the consultation paper. Our preferred position is that financial hedges, including historical long-life arrangements, should be accepted as delivering on the reliability requirement of the Guarantee for large customers like smelters. Where there are historical long life arrangements these should also be accepted as delivering on the reliability requirement of the Guarantee.

It should also be noted that any new requirement beyond the existence of historical contracts and certain types of already widely used financial contracts – such as the options of certification, physical backing, or physical ownership as countenanced on page 38 of the

Consultation Paper – would be a fundamental change to the nature of contracting in the electricity market. As well as triggering many potential unintended consequences, such a change would also introduce new elements of risk and uncertainty, the costs of which must be borne somewhere in the system and could undermine one of the prime objectives of bringing down electricity prices.

The Guarantee would be an unacceptable change to our industry's current contracts and the nature of the electricity contracting market if a requirement beyond the existence of typical financial contracts that currently operate in the NEM, was required to meet the reliability component.

Ongoing close engagement with electricity users is essential

As outlined above, the EITE exemption will be critical to our industry's viability; and the stability of our existing long-term electricity contractual arrangements require a particular approach to the reliability requirement. As a result it will be critical that the ESB - its component bodies, and the COAG Energy Council – consult closely with large electricity users during the development of these and other components on the Guarantee and other elements of energy policy reform.

Our industry has a proven track record in engaging constructively in policy development processes such as this and it has been demonstrated on many occasions that critical elements of policy implementation can only be successfully resolved by engaging closely with parties who are regulated, liable or otherwise directly impacted.

Additional measures needed to ensure competition in electricity markets

The Aluminium Council is of the view – shared by many – that delivering electricity prices efficiently and at affordable price levels, requires strong competition at all stages of electricity supply (including generation, retail, and provision of associated services such as reliability and emissions).

We note that footnote #31 on page 56 states “A workably competitive market is one in which prices tend to efficient costs over time, quality of service matches consumer expectations and choice of products and services is consistent with consumers’ preferences”. Our observed experience is that the NEM is currently not ‘workably competitive’.

In relation to the proposed Guarantee our competitiveness concerns are two-fold:

1. That the requirements of the Guarantee will further enshrine the competitive advantage held by dominant players in the market. These players will be in the best position to meet constraints of reliability and emissions; are able to influence, through the provision of contracts, the ease with which smaller players can meet the

requirements; and are more likely to meet reporting and regulatory requirements at lower cost per MWh.

2. In the absence of complementary measures which dilute or ameliorate the dominant positions of a small number of players, the theoretical benefits of any economic policy measure – such as the Guarantee – will accrue more to the dominant players and less to the final customers.

The consultation paper notes issues of market power and competition. However no recommendations are made on whether and how they should be addressed.

The claimed benefits of the Guarantee are based on predictions of higher levels of contracting, more competition in contract markets, greater incentives for generators to be dispatched in the spot market and therefore lower prices. The justification for this view is supported by economic modelling that incorporates most of those claimed benefits as input assumptions. Importantly no alternative scenarios are considered, such as those with reduced levels of competition.

We recommend that, as a minimum, the Guarantee should include specific elements to:

- Regularly review and report on issues of market power and competition; and
- The ability for an appropriate body (e.g. the AER or the ACCC) to intervene to ensure sufficient levels of competition so that the benefits of policy are delivered to electricity customers.

Reporting and regulatory costs must be kept to a minimum

We note that, even at this early stage of policy design, the proposal necessarily considers reporting and verification of relevant information and proposals for the provision of additional information.

Our experience has been that reporting requirements of this type rarely turn out to be as light-handed as initially conceived, or at a level that could be considered efficient.

We urge the ESB to be vigilant in keeping scheme design as simple as possible and reporting and regulatory costs to a minimum as this will be essential in keeping scheme costs low, increasing market transparency and avoiding additional barriers to competition.

Willingness of dispatchable generation to increase contracting levels is unknown

We remain concerned, even under the proposed Guarantee, about the willingness of dispatchable generators to enter into long-term contracts in a market with increasing levels of intermittent generation with low variable costs and where the intermittent generation has limited commercial risk if not dispatched during periods of temporary excess supply.

If 'baseload' generators cannot secure dispatch even at minimum output when a temporary excess of low-cost intermittent generation is available, they are less likely to commit to long-term contractual arrangements because of the high commercial risk of uncertain market dispatch.

In our view it is important in the design of The Guarantee to give full consideration to the interaction of the reliability and emissions reduction elements and the impact on the demand for, and the supply of, long-term electricity contracts.

Additional comments

Answers to some of the specific questions posed in the consultation paper are provided in the attachment to this letter.

In addition we endorse the ESB's implied view that the following three themes are critical to the success of the proposed Guarantee:

- The Guarantee itself will not solve all, or any, of the challenges facing the National Electricity Market. A well designed and efficient suite of complementary policies is also required including the recommendations from the Finkel Review; initiatives to increase the competitiveness and magnitude of domestic gas supplies; and measures to increase levels of competition in electricity markets.
- The implementation of the Guarantee should seek to utilise and build on the benefits of the existing market. Care should be taken not to stifle or unpick the positive elements of the current market structure.
- Given the scale of the intervention being proposed, great care needs to be taken to avoid unintended consequences. Given such consequences are almost, by definition, impossible to predict (unintended), measures should be available to identify and address them as they occur. The frame of reference should be the objective of the National Electricity Law – the long-term interests of consumers.

I am happy to provide further information on any of the issues raised in this letter. The Council looks forward to responding further through the next phase of development of the National Energy Guarantee.

Yours sincerely



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Att.

ATTACHMENT

Specific answers to questions posed in the consultation paper.

3.2.1

What are stakeholders' views on whether the compliance year should be a calendar year or a financial year, noting that EITE exemption processes under the RET use calendar years, whereas emissions reporting obligations relate to financial years?

While there is a potential misalignment under either arrangement (unless there are further changes), the aluminium industry prefers that the compliance year follow the existing arrangements for the RET (the existing electricity scheme) and be based on calendar years

3.2.2

What are stakeholders' views on the process to calculate a retailer's load?

This needs to be considered in the context of the overall model. For example, if the policy sets a retailer's (or customer's) obligations to contract in the future, based on customer load that they held in the past and may not have contracted in the future, this increases their commercial and financial risks by asking them to contract for load they do not hold, thereby asking them to engage in speculation rather than hedging for prudent risk management purposes.

3.3.2

What are stakeholders' views on how to determine the emissions per MWh to assign to contracts that specify an emissions level but do not specify a generation source?

What are stakeholders' views on how the contract market may evolve to support this type of compliance with the emissions requirement?

There will need to be a shift in the existing design and operation of the NEM for this to be meaningful as currently the NEM is a pool of electricity from a range of sources. For this reason, it is not possible for any retailer who supplies from the NEM to accurately claim that their electricity comes from one particular source. Accordingly the emissions component of the Guarantee should be designed to allow the emissions 'value' of an electricity supply to be separated from the financial hedge that covers the same supply - to enable recovery of the values in separate arrangements. This would assist in minimising disruptive changes to the current nature of financial contracting in the electricity market.

3.3.3

What are stakeholders' views on the appropriate emissions level to assign to contracts that do not specify an emissions level or generation source?

The appropriate emissions intensity to assign to contracts that do not specify an emissions level or generation source is the average emissions intensity in the NEM region to which this contract applies.

What (if any) impact would these approaches to determining the deemed emissions level have on the liquidity and availability of those types of contracts?

Increasing the number of types of different contracts and/or increasingly customising contracts to cater for different emissions levels is likely to reduce contract liquidity.

3.4.1

Should the emissions requirement allow for unlimited carry-over of overachievement or specify limits on the carry-over of overachievement?

The ability to carry-over limited over- and under-compliance from year to year will be critical to workability of the scheme;

If limits are to be specified, what should those limits be and how should they be designed? For example, should the size of limits vary inversely with the size of the retailer's load? This could give more flexibility to smaller retailers.

The level of carry-over of overachievement and underachievement should be set at a level that: allows flexibility; minimises compliance costs; but avoids undermining the intent of the Guarantee or the timely meeting of targets.

3.4.2

What are stakeholders' views on the deferral of compliance?

The ability to carry-over limited over- and under-compliance from year to year will be critical to workability of the scheme;

Should all retailers be able to carry forward a fixed amount or should it be set proportionally to a retailer's load? This could give more flexibility to smaller retailers than larger ones. If so, would any provisions need to be introduced to prevent large retailers re-organising themselves as several small retailers in order to gain the benefit of the higher limit?

Some EITE facilities that are market customers may have small components of their electricity supply that do not receive an EITE exemption. Flexible options will be needed to enable cost-effective compliance for these small loads. A fixed limit (rather than

percentage) for use of offsets, and/or for carry forward of over- and under- compliance may be an effective way to achieve this.

3.4.3

If offsets are permitted by the Commonwealth Government:

- Should limits on individual retailer's use of offsets be based on the size of retailers' loads, such that offsets represent the same proportionate share of retailers' emissions regardless of retailer size?
- Or, instead, should limits on individual retailer's use of offsets be based on the size of retailers' loads, such that offsets represent the same proportionate share of retailers' emissions regardless of retailer size?
- What are the pros and cons of each of the above approaches?
- If limits on use of offsets are independent of retailer size, how should the risk of large retailers splitting into several smaller entities for the purposes of increasing their overall offset limit be addressed?
- What (if any) requirements to use within-NEM opportunities before using offsets are appropriate?

Some EITE facilities that are market customers may have small components of their electricity supply that do not receive an EITE exemption. Flexible options will be needed to enable cost-effective compliance for these small loads. A fixed limit (rather than percentage) for use of offsets, and/or for carry forward of over- and under- compliance may be an effective way to achieve this.

3.6.3

Is there a need for retailers or generators to report contract pricing information as part of the input into the registry?

There is no need, under the purposes of the Guarantee, for regulators to access price information for contracts. Therefore retailers and generators should not be required to report pricing information under the Guarantee.

3.7.1

What are stakeholders' views on how the Guarantee may impact on competitive market?

In relation to the proposed Guarantee our competitiveness concerns are two-fold:

1. *That the requirements of the Guarantee will further enshrine the competitive advantage held by dominant players in the market. These players will be in the best position to meet constraints of reliability and emissions; are able to influence, through the provision of contracts, the ease with which smaller players can meet the requirements; and are more likely to meet reporting and regulatory requirements at lower cost per MWh.*

2. *In the absence of complementary measures which dilute or ameliorate the dominant positions of a small number of players, the theoretical benefits of any economic policy measure – such as the Guarantee – will accrue more to the dominant players and less to the final customers.*

The consultation paper notes issues of market power and competition. However no recommendations are made on whether and how they should be addressed.

We recommend that, as a minimum, the Guarantee should include specific elements to:

- *Regularly review and report on issues of market power and competition; and*
- *The ability for an appropriate body (e.g. the AER or the ACCC) to intervene to ensure sufficient levels of competition so that the benefits of policy are delivered to electricity customers.*

4.2.2

Stakeholder views are sought on options for setting the emissions targets under the Guarantee

Care should be taken in assuming that the optimal outcome for the economy is that the electricity sector meets its pro-rata component of the national emissions reduction targets. While arguments have been put by others regarding the appropriate level of emissions targets in the electricity sector, these arguments are based on modelled costs of emissions reductions and modelling of the NEM – both of which have been found to be regularly unreliable in predicting real world cost impacts. There should be some mechanism to ensure, over time, that marginal abatement costs in the electricity sector do not outweigh costs in other emitting sectors;

4.2.5

Stakeholder views are sought on the proposed approach to setting the electricity emissions targets under the Guarantee and interaction with state renewable energy schemes.

The preference of the Council is that there should be a single NEM-wide target rather than having separate state based renewable energy schemes that are separate or additional to this.

4.3.2

Stakeholder views are sought on issues to be addressed in exempting EITE activities from the emissions requirement of the Guarantee

The proposal to exempt electricity used to carry out EITE (emissions-intensive and trade-exposed) activities (section 4.3.1 of the consultation paper) will be vital to the ongoing viability of many businesses in Australia.

Recognising that many industrial electricity users have in place long term arrangements, direct exposure to the emissions requirement of the Guarantee - combined with the consistency and reliability of electricity supply required – would significantly increase their electricity costs. Despite recent improvements in technology and reduction in capital costs, renewable electricity sources in Australia are not yet cost competitive when considered on a ‘firmed supply’ basis.

The threat to industry viability is well understood by those who have worked on energy and climate policy issues and is the basis for an exemption that applies in respect of the Renewable Energy Target, hence the inclusion of the EITE exemption in the Energy Security Board (ESB) design. The Aluminium Council is strongly supportive of the EITE exemption as a fundamental design element of the Guarantee.

The proposed approach – to exempt electricity used in EITE activities in a manner consistent with the current exemption under the RET – is an appropriate way to implement this component.

The exemption of electricity used in EITE activities must also include effective exemption of self-generated electricity at EITE facilities – as exists under the current RET.

Some EITE facilities that are market customers may have small components of their electricity supply that do not receive an EITE exemption. Flexible options will be needed to enable cost-effective compliance for these small loads. A fixed limit (rather than percentage) for use of offsets, and/or for carry forward of over- and under- compliance may be an effective way to achieve this.

4.4

Stakeholder views are sought on whether retailers should be allowed to use external offsets to meet a proportion of their emissions requirement. In particular, views are sought on:

- Whether there is a strong rationale for the use for offsets within the Guarantee
- The impact allowing offsets would have on investment under the Guarantee
- If offsets were to be used to help achieve compliance with the emissions requirement, what would be an appropriate limit for their use?

Some EITE facilities that are market customers may have small components of their electricity supply that do not receive an EITE exemption. Flexible options will be needed to enable cost-effective compliance for these small loads. A fixed limit (rather than percentage) for use of offsets, and/or for carry forward of over- and under- compliance may be an effective way to achieve this.

5.3.2

What are the stakeholder views on the length of the forecasting period?

Should the existing ESoO and MTPASA forecasting processes be adapted for determining the gap, or should a separate bespoke process be developed?

What elements of the current MTPASA and ESoO processes should be reviewed in light of the potential for the process to lead to a compliance obligation? E.g. how should AEMO treat inputs from generators such as their forced outage rate or summer capacity if these assumptions could lead to a triggering of an obligation?

Should AEMO be able to determine assumptions independently or should responsibility for the accuracy of assumptions be placed on the market participant?

How should the forecasting methodology and assumptions be consulted on?

If AEMO provides a forecast that under-estimates reliability and system reliability issue ensue, this would be expected to attract significant political and media attention and criticism of AEMO. Therefore, the incentive is for AEMO to forecast conservatively, which would increase the costs to customers. To minimise this risk, there needs to be sound governance and careful independent oversight of the forecasting process.

5.6

What are the stakeholder views on the types of contracts that should be considered eligible for the purposes of the requirement?

The need for reliability, and their high exposure to electricity costs, have led smelters to enter into long-term contractual arrangements. Where the smelter or refinery directly participates in the NEM, these are of the type outlined in the consultation paper – financial hedges such as swaps with alternative arrangements only the case where the smelter or refinery does not directly participate in the NEM.

The counter-party to these large long term contracts can only manage their potential price exposure if they have access to firm dependable electricity generation (enabling them to cover their hedged position), and accordingly each of these arrangements is with a counter-party that has a significant generation portfolio

The financial hedges have ensured the significant quantity of firm generation required to sustain the hedged portion of smelter load is available within respective NEM regions. Financial contracts of this type are necessary to deliver the reliability requirement of the Guarantee – as outlined under the sub-heading ‘Financial contracts’ on page 37 of the consultation paper. Our preferred position is that financial hedges, including historical long-life arrangements, should be accepted as delivering on the reliability requirement of the Guarantee for large customers like smelters. Where there are historical long life

arrangements these should also be accepted as delivering on the reliability requirement of the Guarantee.

The Guarantee would be an unacceptable change to our industry's current contracts and the nature of the electricity contracting market if a requirement beyond the existence of typical financial contracts that currently operate in the NEM, was required to meet the reliability component.

Do stakeholders consider eligible contracts should be financial, or have a link to physical capacity?

See answer above. Financial hedges such as swaps should be eligible to meet the reliability component. Any requirement for a further link to physical capacity would be – for our industry – an unacceptable change to the nature of contracting for electricity and existing contractual arrangements.

5.7.3

What are the stakeholder views on the proposed method of allocating the gap to retailers?

The obligation and/or cost to remedy any reliability shortfall in a NEM region must be allocated to those retailers/market customers who are short on contractual arrangements for generation. There should be no cost to a market customer who has met their compliance requirements.

5.7.4

What are the stakeholder views on extending the reliability requirement to large energy users that are not market customers?

The aluminium industry includes some of the largest energy users in the NEM that are not market customers. While we can see the impact on retailers of significant volumes in short-term electricity contracts with C&I customers, our contracts tend not to be short-term in nature. Furthermore, we cannot see how the proposal to extend the reliability requirement to those customers can be effectively implemented without the potential for significant unintended consequences.

However, it is important that retailers should not be allowed to pass any additional costs of the obligation on to EITE customers

5.9

What are the stakeholder views on the including a procurer of last resort function in the reliability requirement?

The reliability requirement of the Guarantee should be designed and implemented so as to do the work of ensuring the necessary reliability. The design of the procurer of last resort role should be so as to ensure it is only enacted in a very limited range of circumstances.

5.11.1

What are the stakeholder views on how the Guarantee may impact on competitive markets?

In relation to the proposed Guarantee our competitiveness concerns are two-fold:

- 1. That the requirements of the Guarantee will further enshrine the competitive advantage held by dominant players in the market. These players will be in the best position to meet constraints of reliability and emissions; are able to influence, through the provision of contracts, the ease with which smaller players can meet the requirements; and are more likely to meet reporting and regulatory requirements at lower cost per MWh.*
- 2. In the absence of complementary measures which dilute or ameliorate the dominant positions of a small number of players, the theoretical benefits of any economic policy measure – such as the Guarantee – will accrue more to the dominant players and less to the final customers.*

The consultation paper notes issues of market power and competition. However no recommendations are made on whether and how they should be addressed.

We recommend that, as a minimum, the Guarantee should include specific elements to:

- Regularly review and report on issues of market power and competition; and*
- The ability for an appropriate body (e.g. the AER or the ACCC) to intervene to ensure sufficient levels of competition so that the benefits of policy are delivered to electricity customers.*