25 March 2024

Department of Climate Change, Energy, the Environment and Water

Submitted via consultation hub

CIS – Implementation Design Paper

The Australian Financial Markets Association (**AFMA**) is responding to the Department of Climate Change, Energy, the Environment and Water's (DCCEEW) implementation design paper to expand the scope of the Capacity Investment Scheme (CIS).

AFMA is the leading financial markets industry association promoting efficiency, integrity and professionalism in Australia's financial markets, including the capital, credit, derivatives, foreign exchange, energy, carbon, and other specialist markets. Our membership base is comprised of over 130 of Australia's leading financial market participants, including many energy firms who are key participants in the National Electricity Market (NEM).

Key Points

- **CIS participants should be incentivised to participate in the financial market.**
- **AFMA supports considering alternative contract structures for CIS projects.**
- **Contractual restrictions on CIS participants should be minimized.**

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1. Wholesale market participation

AFMA supports developing the CIS as a mechanism that complements existing market arrangements and incentivises participation in the financial market. While we appreciate that DCCEEW has made some improvements to the CIS since the Consultation Paper, we consider the design still contains a number of features which will disincentivise participation in the financial market, potentially minimising the benefit of the CIS and increasing its cost to taxpayers.

1.1. Collar structure

As discussed in our submission to the Consultation Paper,[1] AFMA considers that the collar structure is not the most efficient design for the CIS and that it will; reduce competition to provide CIS products, increase costs to taxpayers and reduce the capacity that is made available to the market.

We consider that by limiting the potential upside proponents can gain from projects the collar structure will:

- reduce the number of market participants willing to participate in the CIS;
- result in participants requiring higher revenue floors to off-set the lost potential upside; and
- lead to less efficient commercial and operational decisions as participants are disincentivised from earning revenue above the ceiling.

AFMA considers the collar structure is likely to reduce competition to provide CIS products, increase costs to taxpayers and reduce the capacity that is made available to the market. We maintain our

[1] https://afma.com.au/policy/submissions/2023/r48-23-cis-consultation-paper.pdf?ext=.pdf

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recommendation that DCCEEW reconsider this structure and consider a simpler structure such as floor contracts.

1.2. Alternative contractual structures

AFMA welcome the Design Paper's consideration of alternative contract structures to the original collar structure and encourage DCCEEW to continue exploring alternative structures. We consider that there may be merit in exploring a range of commercial structures that best achieve the schemes' objectives while retaining commercial incentives for proponents.

The option structure proposed in the paper appears to be based on the approach taken in NSW's Long Term Energy Service Agreements (LTESA). While this structure has some benefits over the CIS collar structure, a number of our members have provided feedback that:

- in practice it does not incentivise market participation as much as anticipated as lenders are typically uncomfortable with proponents taking market risk and require them to exercise the options every year to guarantee a minimum level of revenue. Which removes much of the benefit of the design;
- the complexity of the LTESA framework has deterred a number of our members from participating in it, which potentially increases its cost.

AFMA therefore thinks a simpler model may be more appropriate to encourage participants to participate in the wholesale market.

The Design Paper also proposes a volumetric exclusion model, the paper does not provide much detail about how this model would work but we have the following comments. Financial contracting is not directly linked to the physical output of a unit therefore it may be impractical to attempt to exclude a percentage of a CIS unit output from the scheme based on the existence of financial contracts. Additionally, derivative contracts such as swaps and caps do not provide guaranteed revenue, therefore excluding them entirely from the calculation of floor payments would expose CIS providers to the risk of lower than anticipated revenue from derivative contracts; which could undermine the incentives the floor is intended to provide.

AFMA supports exploring alternative commercial models and encourages DCCEEW to continue working with industry to develop a model that will incentivise participation in the wholesale market.

1.3. LOR 3 requirements

As stated in our earlier submission, AFMA considers that operational restrictions on units should be limited to ensure units are able to participate fully in the market. We support DCCEEW's decision to remove the requirements for units to be available when spot prices exceed particular levels, but note that the requirement to be available during LOR 3 events has remained.

The Design Paper acknowledges the distortionary impact of the LOR 3 requirement but justifies it by saying that "it is important that projects receiving financial support prioritise making a system reliability contribution during low probability periods of system stress." AFMA considers that the purpose of the CIS is fundamentally different from emergency capacity schemes such as the RERT or AEMO's directions powers. The CIS exists to fund capacity that benefits the market at all times rather than focusing on providing capacity at critical times, for which existing mechanisms such as the RERT and AEMO's directions powers, already exist. The purpose of the CIS should be to increase capacity generally, making it less likely that an LOR 3 event will occur.

Our members have provided feedback that the LOR 3 requirement has proved problematic in NSW's scheme. LOR 3 events are, by their nature, unpredictable and will generally occur with very short notice. This means that short duration storage units must reserve part of or all of their capacity to be confident that they will be available during an LOR 3 period. Our members have reported two impacts of this requirement in NSW:

a) Operational – units withhold capacity during normal market operations to ensure they can meet their contractual obligations during an LOR 3 event.
b) Investment – proponents' models must make more conservative estimates about the amount of run time a unit will have as capacity must be reserved to meet their contractual LOR 3 requirements.

The first results in less capacity being available to the market, which will generally lead to higher prices. While the second has resulted in some participants choosing not to participate in the NSW scheme and higher costs for those who do, which we understand has made the NSW tenders less competitive and more expensive than they may have been without the LOR 3 requirement.

AFMA recommends that the CIS design should not include an LOR 3 requirement. We consider that removing the LOR 3 requirements will result in more capacity being made available in the market and reduce the cost of the CIS to taxpayers; and that existing mechanisms, such as the RERT and AEMO's directions powers, are adequate to manage relatively rare LOR 3 events.

Alternatively, if DCCEEW decides to retain the LOR 3 requirement AFMA suggests that the penalties for non-compliance with it should be lowered to reduce the disincentive for CIS proponents to participate in the wholesale market. We note that the he Term Sheet for the Vic / SA pilot tender limits the penalty to a proportionate reduction in the level of payments that could be made in a given period. We consider that this is a more reasonable approach.

AFMA Recommendations

i. AFMA supports exploring other contract structures as alternatives to the current collar structure.
ii. The CIS should not include an LOR 3 requirement.
iii. If the LOR 3 requirement is retained the penalties should be lowered.

2. Eligible wholesale contracts

AFMA appreciates DCCEW's efforts to provide clarity about what will be an eligible contract and would like to provide some feedback on the treatment of eligible contracts. The Design Paper proposes that eligible contracts must be for at least one year. AFMA would like to point out that many derivative contracts will be for substantially shorter periods. ASX listed electricity swaps and caps have durations ranging from one to three months and many OTC products will have similar terms. AFMA considers that there should be no barriers to CIS providers participating in the financial market and, particularly in the case of storage providers, we are keen to see them being able to offer firming products such as caps or possibly the ASX's proposed new peak swap.[2] Failure to treat shorter term derivative contracts as eligible contracts could result in CIS providers being exposed to double liability if the costs associated with them are not considered as part of the revenue determination, which we anticipate would discourage CIS providers from entering into derivative contracts. Therefore, AFMA does not

[2] https://www.asxenergy.com.au/newsroom/industry_news/consultation-on-asx-australia

think that there should be a requirement for eligible wholesale contracts to have a term of at least one year.

The Design Paper requires eligible wholesale contracts to not expose the CIS provider to "make net swap payments when negative prices occur." It is prudent for DCCEEW to look to manage the Government's exposure to negative prices and to ensure the incentives for CIS providers and taxpayers are aligned. However, AFMA is concerned that a strict prohibition on CIS providers ever making swap payments when negative prices occur may inhibit their ability to participate in the wholesale market, as they would be unable to enter into any contracts that could potentially expose them to make any payments for even brief periods of negative prices. AFMA suggests that it may be more appropriate to manage taxpayers' exposure to negative prices by requiring CIS providers to minimise their exposure to negative prices and by capping the Government's liability to compensate CIS providers for losses incurred during periods of negative prices. We consider this would protect taxpayers without unduly restricting CIS providers from participating in the financial market.

AFMA Recommendations

iv. Eligible wholesale contracts should not be limited to contracts of over a year duration.

v. CIS providers should be required to minimise their exposure to negative prices.

vi. Taxpayers' exposure to negative prices should be managed through liability caps rather than restrictions on the contracts CIS providers can enter into.

3. Corporate structures

DCCEEW's requirements for legal and accounting separation for CIS projects will present challenges for vertically integrated businesses and standalone proponents.

For vertically integrated businesses there will be challenges regarding the allocation of costs and management of financial services licencing requirements. AFMA's members consider that the allocation of revenue and costs to CIS projects will be complicated in larger vertically integrated businesses with integrated portfolios and shared corporate services. We encourage DCCEEW and AEMO Services to work with the industry to develop clear guidance on how costs and revenue should be allocated.

Most electricity businesses are required to hold Australian Financial Services Licences (AFSL) to allow them to deal in financial products related to electricity. As the costs of obtaining licences and meeting the related compliance obligations are considerable, most firms will hold a single AFSL within their group and all dealings in financial products will be executed by a single team located within the licence holding legal entity. It is unlikely to be practical for special purpose vehicles set up to hold CIS assets to have their own AFSL or contracting team, therefore any contracts entered into for the CIS project are likely to be undertaken by staff within the licenced entity. It would be helpful if DCCEEW could provide guidance about how they expect CIS projects to contract in a way that is consistent with their AFSL requirements.

The requirement for the special purpose vehicle to be the registered participant and operator of a project will present challenges for both vertically integrated and standalone proponents that we think will discourage them from participating in the wholesale market. AFMA understands that it is common for owners of renewable projects to enter into agreements with another entity (related or otherwise) which give the trading rights for the project to the other entity in exchange for regular payments. Requiring the special purpose vehicle to be the operator and registered participant for

the project would prevent them from entering into this type of agreement. AFMA considers that this requirement should be reviewed to ensure that it does not discourage participation in the wholesale market.

AFMA Recommendations

vii. DCCEEW should work with the industry to develop guidance about allocation of revenue to CIS projects within vertically integrated portfolios.

viii. DCCEEW should consider the interaction of its separate legal entity requirements with businesses AFSL requirements.

ix. CIS special purpose vehicles should not be required to be the registered participant and operator of CIS projects.

AFMA would welcome the opportunity to discuss this submission further and would be pleased to provide further information or clarity as required. Please contact me at lgamble@afma.com.au or 02 9776 7994.

Yours sincerely,

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