

30 August 2023

Department of Climate Change, Energy, the Environment and Water



Submitted via Consultation hub

Dear Sir/ Madam,

### **Capacity Investment Scheme – Consultation Paper**

The Australian Financial Markets Association (AFMA) is responding to the Department of Climate Change, Energy, the Environment and Water's (DCCEEW) consultation paper on the proposed Capacity Investment Scheme (CIS).

AFMA is the leading 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 role is to provide a forum for industry leadership and to advance the interests of the markets and their respective participants. Our membership is comprised of over 125 of Australia's leading financial market participants, including many of the energy firms who participate in the National Electricity Market (NEM). While the CIS will apply beyond the NEM, our comments are limited to its impact in the NEM and any resulting impact on our members.

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#### **Key Points**

- **AFMA supports incentivising new dispatchable capacity to participate in the market**
- **The CIS should be designed to minimise costs to energy users and taxpayers**
- **Government should provide clarity about the scale of the CIS and about the future of the Retailer Reliability Obligation (RRO)**
- **A separate mechanism is likely to be required to support the continued operation of non-renewable generation at the levels currently anticipated by AEMO**

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AFMA welcomes DCCEEW's proposal for a CIS that supports new investment in dispatchable capacity which is incentivised to participate fully in the NEM. We consider that incentivising new capacity to earn most of its revenue through the market is likely to strengthen the market and reduce the overall cost of the scheme for taxpayers and energy users. Our submission focuses on enhancements to the CIS that AFMA considers will better achieve its objectives and reduce the cost of the scheme to taxpayers and energy users.

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## 1. Scale of the CIS

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### Key Points

- **The market needs clarity about the actual scale of the CIS**
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#### 1.1. Budget transparency

The CIS is an ambitious program that the consultation paper “expects will bring forward at least \$10 billion of new investment and 6 GW of clean dispatchable capacity by 2030,” which, according to AEMO’s July NEM Generation Information, is over four times the nameplate capacity of all investment that has commenced full commercial use in the NEM since 2017.<sup>1</sup> The CIS will therefore be one of the most significant drivers of new capacity investment in the coming years and the resulting assets will have a major impact on the electricity market. AFMA therefore considers that it is critical that there is as much transparency as possible about the scale of the scheme to allow investors and market participants to incorporate the impact of the CIS into their business and risk management decisions.

The consultation paper talks about the CIS underwriting 6 GW of investment by 2030 but is also clear that, if necessary, the actual amount of capacity underwritten will be constrained to ensure it remains within the allocated budget. The CIS was funded in the 2023-24 Budget, but the level of funding was not disclosed “due to commercial sensitivities.”<sup>2</sup> The result is that, currently the market does not know what resources are available to achieve the 6 GW target and will be unable to assess the extent to which the costs of projects underwritten by the CIS are consistent with the available budget achieving the target. It is therefore unclear how much capacity will actually be underwritten by the CIS and if all of the proposed tenders through to 2027 are likely to occur, or if the funding may run out after the early tenders.

To provide the market with greater clarity about the scale and roll out of the CIS, AFMA recommends that DCCEE should publish the total budget for the CIS and that as much information as possible should be provided about the amount of funding provided to all projects underwritten by the CIS. We do not consider that commercial in confidence protections are appropriate for projects underwritten by the CIS as we think it is more important to provide transparency about the use of public money and the likelihood of the CIS meeting its 6 GW target.

#### 1.2. Assessing the cost to taxpayers

The CIS, as currently proposed, is a contingent liability for the Commonwealth rather than a direct cost. Under the current proposal the Commonwealth will only incur an actual cost if a project fails to achieve its annual net revenue floor and will potentially make a profit from the scheme if projects exceed their net revenue ceilings. The consultation paper is clear that the size of the scheme may be constrained by the available funding but the actual cost for a project will not be known until the end of its CIS contract so it is unclear how the Commonwealth will assess the cost of the scheme during the initial funding period to 2027.

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<sup>1</sup> <https://aemo.com.au/energy-systems/electricity/national-electricity-market-nem/nem-forecasting-and-planning/forecasting-and-planning-data/generation-information>

<sup>2</sup> p66 Budget Paper No. 2 2023-24

Below is a simplified example for a 10-year CIS contract with a \$1m revenue floor and a \$5m revenue ceiling. For simplicity we have assumed the Commonwealth is liable for 100% of the revenue floor and receives \$50% of revenue above the ceiling.

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Total
<b>Contingent liability</b>	-\$1m	-\$1m	-\$1m	-\$1m	-\$1m	-\$1m	-\$1m	-\$1m	-\$1m	-\$1m	-\$10m
<b>Revenue</b>	\$0.5m	\$1.2m	\$2m	\$4m	\$7m	\$2m	\$4m	\$0.5m	\$7m	\$2m	30.2m
<b>Cth profit or loss</b>	-\$0.5m	\$0	\$0	\$0	\$1m	\$0	\$0	-\$0.5m	\$1m	\$0	\$1m

In year 1, the Commonwealth has a \$10m contingent liability but by the end of year 10 the Commonwealth has made a \$1m profit from underwriting the project. It is unclear to AFMA how the Commonwealth would budget for a project with an arrangement like this. We think providing clarity about how the CIS will be budgeted for will be important to assist the market to understand the impact of the CIS. We think this will be particularly important for the Commonwealth during the initial funding period to 2027 as we anticipate that majority of projects funded would not begin generating any revenue until at least the end of the period. Provision by the Commonwealth of projected financial outcomes may assist in demonstrating how the CIS is working.

**AFMA Recommendations**

- i. DCCEW should provide the market with clarity about the scale of the CIS by:
  - a. Publishing the budget for the CIS
  - b. Providing as much financial information as possible about projects underwritten by the CIS
- ii. Provide guidance about how it will manage contingent liabilities

**2. CIS Design**

AFMA considers the CIS is an important mechanism to ensure that adequate dispatchable capacity is built to ensure the market is able to continue to function as coal fired generation retires. As DCCEW has recognised, incentivising this capacity to earn revenue in the market will be critical to ensuring that it is built at the lowest cost to taxpayers and energy users, and with the least disruption to the functioning of the market. AFMA supports this approach and notes AEMO Services observations that projects have been delivered under NSW’s Long Term Energy Service Agreements (LTESA) at significantly lower cost to taxpayers than under the contracts for difference seen in other markets.

We consider that the best way to achieve the CIS goals is to maximise incentives to participate in the market and ensure that any performance requirements do not unduly restrict units’ ability to operate commercially. We consider this to be particularly important for the success of the CIS as, unlike the other capacity mechanisms such as the Reliability and Emergency Reserve Trader (RERT) framework, the CIS should support capacity that is intended to support the market functioning all of the time, rather than providing an emergency reserve that can be called upon during emergencies. We also consider that Government should provide

guidance about the arrangements for accounting for CIS providers revenue and the role of the RRO following the implementation of the CIS.

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### **Key Points**

- **CIS design should facilitate participation by as many parties as possible**
  - **Incentives to participate in the market should be maximised**
  - **Performance requirements should not unduly restrict units' ability to operate commercially**
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### **2.1. Collar**

The CIS adopts a similar approach to NSW's Long Term Energy Service Agreements (LTESA), the main difference is that while NSW's scheme uses an option structure to underwrite minimum revenue for a project, the CIS is proposing to use a collar structure with a net revenue floors and ceilings. NSW's approach has been operating for some time and we think the CIS could be improved by incorporating some of the lessons learnt in NSW where the complexity of the model has deterred some proponents from participating.

The consultation paper presents the collar structure as a prudent mechanism to minimise the cost to taxpayers by:

1. Encouraging units to recover costs through the market, thereby limiting taxpayers' liability to make payments to meet the net revenue floor; and
2. Sharing profits above the net revenue ceiling, to potentially allow the Commonwealth to profit from the CIS.

While we share DCCEEW's admirable desire to minimise costs to taxpayers we do not think the collar approach is necessarily the best way to do this.

Intuitively, the revenue ceiling appears to be a way to minimise the Commonwealth's exposure and potentially contain market prices but in practice we do not think this will work as intended. The effect of the revenue ceiling is to limit the potential upside a proponent can gain from a project, and we anticipate that this will reduce the number of participants who wish to participate making the process less competitive. Additionally, given the reduced prospect of upside from their investment participants are likely to be less willing to take on risk and will require higher revenue floors to ensure a commercial outcome. We consider that both of these outcomes are likely to increase the cost of the CIS for taxpayers. Some AFMA members have indicated that they do not expect to participate in the CIS under the proposed rules and we anticipate that fewer people participating in the tenders is likely to lead to higher costs.

Additionally, we anticipate that the collar may lead to less efficient commercial and operational decisions. AFMA's view is that the revenue ceiling will disincentivise units from earning revenue above the ceiling. This may result in them contracting and operating their units in a way that minimises their need to operate the unit once the revenue ceiling is hit, which could lead to less capacity being available to the market resulting in higher prices for energy users.

AFMA considers that the collar structure is not the best 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 recommend that DCCEEW reconsider this structure and consider a simpler structure such as floor

contracts. We think these structures would achieve better market results and make it easier for proponents and DCCEEW to value CIS contracts.

## **2.2. Performance Requirements**

Prudent contract management dictates that CIS tenders should contain appropriate performance requirements to ensure the Commonwealth obtains value for money, but AFMA considers that the requirements should not unduly limit CIS units from participating freely in the market. We consider that it is appropriate for CIS participants to be subject to contractual requirements regarding delivery of the project and overall availability, but we do not think it is appropriate to impose requirements on them to be available to be dispatched during particular times, such as LOR 3 events or periods of prices above particular levels, as this type of requirement is likely to have a significant impact on the economics of a project and reduce their capacity to provide capacity outside of the specified times.

The consultation paper has proposed that CIS units should have obligations to be available during LOR 3 events, this mirrors current obligations under NSW's LTESA. Our members have provided feedback that this 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 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:

1. Operational – units withhold capacity during normal market operations to ensure they can meet their contractual obligations during an LOR 3 event.
2. 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.

Our members have also provided feedback that requirements for CIS units to be available to be dispatched when prices are above set levels are likely to be counterproductive. AFMA's view is that the current market design adequately incentivises participants to dispatch their units during periods of high prices and that imposing further requirements on CIS units is likely to distort their behaviour in the market as they reserve capacity to be available in the event prices exceed the threshold. We anticipate that this is likely to increase the cost of operating a CIS unit and increase the cost of capacity for the market as a whole.

AFMA recommends that the CIS design should not include an LOR 3 requirement, or other restrictions with a similar impact. We consider that removing the LOR 3 requirements will result in more capacity being available in the market and reduce the cost of the CIS to taxpayers. Additionally, as stated above, we consider that the purpose of the CIS is fundamentally different from emergency capacity schemes such as the RERT or AEMO's directions powers as it should 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. Furthermore, while it is an obvious point, it is worth saying that increasing capacity generally makes it less likely that an LOR 3 event will occur or that the RERT will need to be activated, which would be a better result for the market.

### 2.3. Allocating Costs and Revenue

One of the consequences of the CIS's proposed always on collar structure is that AEMO and the CIS provider will have to be able to allocate costs and revenue to the CIS project. Our members consider that this is likely to be complex, particularly in larger integrated portfolios. We encourage DCCEEW and AEMO to work with the industry to develop guidance on how costs and revenue will be allocated, prior to issuing the first CIS tenders.

### 2.4. Future of the RRO

The RRO was introduced to try and address the risk of an inadequate supply of dispatchable capacity. AFMA considers that there is near consensus in the industry that it has failed to do this; and this view is strengthened by the Government's proposal to introduce the CIS. AFMA was very critical of the RRO in our recent submission to the AEMC's Review of the Operation of the RRO.<sup>3</sup> Our view is that attempting to deal with the lack of physically dispatchable capacity by mandating retailers enter into an inefficient level of contracting is a fundamentally flawed approach. We consider the RRO is unlikely to contribute meaningfully to system reliability but note that it imposes significant costs to retailers and their customers as a result of the need to enter into inefficient levels of hedging.

In our submission to the AEMC's review, we asked policy makers to consider repealing the RRO and replacing it with a mechanism that would incentivise the construction of dispatchable capacity, such as the CIS. AFMA considers that the RRO will not be required after the implementation of the CIS and we encourage Government to provide guidance about the future of the RRO, post the implementation of the CIS. We also note that the Energy Security Board recommended the RRO should be abolished once a capacity mechanism was introduced.

#### AFMA Recommendations

- iii. The CIS collar structure should be replaced by a simpler structure, such as a floor.
- iv. The CIS should not include an LOR 3 requirement or requirements to be available at set price levels.
- v. DCCEEW should work with the industry to develop guidance about allocation of revenue to CIS projects.
- vi. DCCEEW should provide guidance about the future of the RRO following the implementation of the CIS.

### 3. Exclusion of non-renewable capacity

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#### Key Points

- **Alternative mechanisms may be required to support non-renewable capacity**
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AFMA appreciates that the Commonwealth has made a policy decision that the CIS will not support non-renewable capacity. While we do not expect the Government to change its position, we are concerned about

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<sup>3</sup> [https://afma.com.au/getattachment/Policy/Submissions/2023/R01-22-AGD-Privacy-Review-Consultation-\(18\)/R26-23-RRO-Review.pdf?lang=en-AU&ext=.pdf](https://afma.com.au/getattachment/Policy/Submissions/2023/R01-22-AGD-Privacy-Review-Consultation-(18)/R26-23-RRO-Review.pdf?lang=en-AU&ext=.pdf)

the impact of the CIS on existing capacity providers and consider that additional policy measures may be required to ensure the CIS does not lead to a disorderly exit of existing capacity from the market.

The challenges of operating baseload conventional units in a market with increasing quantities of variable renewable generation have been discussed at length. As DCCEEW is aware, the influx of low marginal cost variable renewable generation has contributed to the rapid reduction in the amount of scheduled capacity in the NEM, which has driven the need for the CIS. AEMO's Step Change scenario anticipates that the majority of coal fired generators will retire by 2030 but anticipates a "critical need for peaking gas-fired generation ... through the ISP time horizon to 2050" to provide part of the firming capacity required to support increasing volumes of variable renewable generation.<sup>4</sup> AFMA is concerned that by subsidising the entry of new capacity, without providing any support to existing units, the Commonwealth risks the new units undermining the economics of existing capacity leading them to close sooner than currently anticipated. In a worst case scenario, rather than supplementing existing capacity, CIS units would replace it resulting in a CIS that did not increase total dispatchable capacity.

To avoid this outcome, AFMA recommends that DCCEEW develop policies to support a coordinated closure of coal fired generation and to ensure other existing capacity continues to operate to support the energy transition.

#### **AFMA Recommendations**

- vii. DCCEEW should develop policies to:
  - a. support a coordinated closure of coal fired generation
  - b. ensure other existing capacity continues to operate to support the energy transition

AFMA would welcome the opportunity to discuss the Reliability and Supply Adequacy Framework reforms. Please contact me on 02 9776 7994 or by email at [lgamble@afma.com.au](mailto:lgamble@afma.com.au).

Yours sincerely

**Lindsay Gamble**  
**Policy Director**

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<sup>4</sup> [2022 Integrated System Plan](#)