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Energy and Climate Change Ministerial Council

Submitted by email: energy.consult@dpie.nsw.gov.au

Orderly Exit Management

The Australian Financial Markets Association (**AFMA**) is responding to the Energy and Climate Change Ministerial Council's (ECMC) consultation paper on the development of an Orderly Exit Management (OEM) Framework.

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 125 of Australia's leading financial market participants, including many energy firms who are key participants in the National Electricity Market (NEM).

Key Points

- **A mechanism to ensure the orderly exit of coal fired generation is necessary to provide the market with the certainty it needs to support the transition to net-zero.**
- **The proposed mechanism provides short term certainty about the closure of coal plants but does not provide the medium to long term certainty required for new investment.**
- **Financial contracts purchased by government under the OEM should be offered to the market to boost liquidity and recover some of the cost of the OEM.**

Coal fired power stations currently perform a critical role in the NEM, coordinating their closure in an orderly manner is necessary to provide the certainty necessary to allow the market to invest in new capacity to support the transition to net-zero. AFMA considers that the OEM's governance arrangements should be designed to provide clarity to the market about the timeframes for the closure of coal fired power stations in the short, medium, and long term.

1. Timing of intervention

The OEM appears to have been designed to give governments maximum flexibility when intervening to postpone the closure of a plant, by giving ministers broad discretion and allowing them to withhold making a decision until potentially quite close to the planned closure date. AFMA is concerned this approach does not give the market medium to long term certainty about plant closures. We are also concerned that by delaying the decision to intervene, ministers are likely to find that there will be physical and operational challenges that will limit the options to keep plants operating beyond their proposed closure dates, which could reduce the effectiveness of any intervention.

1.1. Market and investment impact

Under the current arrangements, generators are required to give AEMO notice of their intended closure date and seek an exemption from the AER if it is less than 42 months from the date of giving

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notice. The trigger for the beginning of the OEM process is a generator bringing forward its intended closure date to a date that is less than 7 years from the notice, which could potentially be substantially less than 7 years. Ministers are then able to request AEMO perform a System Needs Assessment either immediately or in subsequent years following the publication of the Electricity Statement of Opportunities. From this point AEMO is required to perform substantial analysis and about the impact of the closure, including identifying alternative options to address the system's needs. AFMA anticipates this work is likely to take at least 6 to 12 months meaning that in a lot of cases it is likely that the minister will not start discussions with the plant until quite close to their proposed closure date, particularly if the System Needs Assessment is not requested at the earliest possible date. The paper notes the first unit the OEM is expected to apply to is currently scheduled to close in August 2025, 19 months from the due date for this consultation. We anticipate that this is likely to result in ministerial decisions being made quite close to the time that a unit is scheduled to close therefore providing limited notice to the market.

The majority of financial market trading generally occurs over a roughly two-year horizon. It is therefore desirable to minimise unanticipated disruptions to the market in the short term to allow the market to correctly price risk over this period, while the market has less trouble accommodating changes in the medium and long term as there is less trading over this horizon. While we consider the OEM governance framework is likely to result in ministerial decisions being made quite late in the closure process AFMA considers that they are generally likely to be timely enough to minimise disruption to the financial market.

However, decisions to invest in new electricity assets to support the net-zero transition are generally made over longer time horizons than transactions in the financial market. As these decisions to build new dispatchable capacity are ultimately what is required to allow the existing coal fired units to retire we consider that it is important that the OEM governance process be designed to provide appropriate medium and long term signals to support these investments rather than as an ad-hoc process reliant on ministerial decisions close to the scheduled closure date of plants. A possible alternative governance approach would be for AEMO to conduct System Needs Assessments for all significant generators that are expected to retire, with ministers' powers to intervene linked to this assessment and with clear timelines about when decisions must be made.

1.2. Physical and operational factors

Australia's aging fleet of coal fired generators are extremely complicated machines whose continued operation depends on ongoing capital investment and detailed maintenance planning. While, with adequate time and capital investment, it is probably possible to keep them operating more or less indefinitely; as they age the cost of continuing to operate them increases and their reliability declines. As a result, at a certain point, their operators will decide that it is no longer economic to keep the plants operating. Once the operator has decided to close a plant, they will put together a detailed plan about how and when to close the plant. From this point maintenance, investment and operational decisions will be designed to only allow the plant safely operate until the planned closure date. Consequences of this will be that the operator will generally need to accept increasingly poor reliability from the plant as it nears closure and investment will not be made to preserve the longevity of the assets beyond the planned retirement date. This could be as simple as not paying to repaint exposed metal components to prevent them from corroding, resulting in the asset deteriorating beyond the point that it can be restored; or failing to book in demand specialist technicians to conduct major overhauls needed to extend the plants life, resulting in substantial delays before this work can be done. Beyond maintenance the operator may also have made a number of commercial and operational decisions that could make it difficult to keep a plant

operating, these include; not renewing key contracts for fuel supply and transmission access and not implementing staffing plans to ensure adequate skilled staff are available to operate the plant.

The result of this is that as plants get close to their planned retirement dates it is highly likely that they will be in poor condition with low reliability and have inadequate access to fuel and staffing, this may mean that extending their operation could be either extremely expensive or practically impossible. In practice we think this means the OEM is likely to give ministers significantly less flexibility to intervene close to a planned closure date than they anticipate.

AFMA Recommendations

i. OEM governance should be designed to give the market certainty about plant closures over the long term, by providing clear timelines about when decisions will be made.

2. Instruments

The OEM is proposed to be implemented through the use of financial contracts entered into between the plant operator and the government. AFMA would like to provide some observations about; how this could be designed to support liquidity in the financial market, the appropriate information arrangements and to offer some caution about the extent to which it will be practical to impose physical performance requirements on aging plants.

2.1. Supporting liquidity

One of the challenges of the energy market transition is that the decline in dispatchable generation has led to a reduction in the number of generators suitable for selling firm financial contracts. This has led to a reduction in the volume of firm contract cover available to retailers to manage their spot price exposure. Currently coal and gas-fired generators are some of the main suppliers of swap and cap cover and prima facie a mechanism, such as the OEM, that is designed to extend their operation should increase the availability of financial hedges.

AFMA considers that the OEM should be designed to improve liquidity in the financial market by ensuring that all swaps and caps bought by government under the OEM are subsequently offered to the market. This would have the dual benefits of improving liquidity in the financial market and reducing the overall cost of the OEM as at least part of its cost could be recovered through the sale of financial products. Additionally, the OEM should not prevent system significant generators from selling additional contract cover beyond that offered under the OEM if they consider their plant can support it as this will also increase the availability of contracts to the market.

Entering into financial contracts and dealing in these products is a non-trivial activity and governments should ensure that they have appropriate arrangements in place to undertake these activities. Some of the issues AFMA thinks ECMC should consider are:

- The treatment of system significant generators that are part of vertically integrated portfolios, including the extent to which they can use the generation to support their portfolio versus supplying hedges to the market;
- Ensuring adequate processes are in place to allow governments to deal in financial products, including holding any necessary licences;
- Appointing appropriately experienced brokers to assist governments to manage the sale process;
- Exploring having the system significant generator offer the contracts to the market directly rather than government.

AFMA would appreciate additional details about how governments intend to manage their activities in the financial market. Providing transparency about governments proposed activities in the financial market is also important as the size of the assets means these transactions are likely to be material to the market.

2.2. Information requirements

The consultation paper contemplates that jurisdictions will explore voluntary negotiated solutions with generators before pursuing a mandatory regulated approach. But the prescribed information requirements, which apply from stage 1, appear to be designed to support a regulatory cost recovery process, which we do not think is appropriate for a negotiated framework. Negotiated agreements are fundamentally different than regulated approaches as they require the parties to agree to the outcome. As a result, the terms of the agreement and the price paid will be the result of a commercial negotiation between the operator and the government rather than the result of a regulatory decision about appropriate cost recovery arrangements for a mandated level of service, it is therefore unnecessary to require the provision of detailed cost data at this stage.

AFMA's view is that the information process should be broken in two with only limited information about the physical characteristics of the plant and its planned retirement provided after a system needs assessment has determined the plant is needed and detailed commercial information only provided to allow the AER to determine appropriate cost recovery arrangements as part of the mandatory operation process in stage 3.

2.3. Performance requirements

The paper contemplates imposing performance requirements on system significant generators and imposing penalties for failure to meet these requirements beyond the financial consequences of failing to generate to support financial contracts. Physical performance criteria are not generally part of financial contracting in the electricity market, and we anticipate that generators will be reluctant to agree to stringent requirements and may require substantial additional compensation to do so, increasing the cost of the OEM overall. While we appreciate that governments will want to have some confidence that system significant generators will provide the anticipated services, we want to caution that, given the age of the units involved, generators will have great difficulty meeting overly ambitious performance criteria regardless of the penalties imposed. We encourage ECMC to keep any physical performance requirements to the minimum necessary, to ensure it is possible for the generators to meet them. We also consider that penalty provisions should be appropriate for the expected capability of the units.

AFMA Recommendations

ii. Swaps and caps purchased under the OEM should be made available to the market.
iii. System significant generators should not be prevented from selling additional contract cover beyond that offered under the OEM.
iv. ECMC should consider how system significant generators that are part of vertically integrated portfolios should be treated, including the extent to which they can use the generation to support their portfolio versus supplying hedges to the market.
v. Governments should provide additional detail about their planned arrangements for dealing in financial products, including if they intend to use brokers.
vi. System significant generators should not be required to provide any prescribed information until after a System Needs Assessment has identified a need for the plant.
vii. Different prescribed information requirements should apply for stage 2 and 3.
viii. Physical performance requirements should be limited to reflect the capabilities of the aging units.

ix.	Penalty provisions should recognise the physical capabilities of older units.

3. Application

AFMA would appreciate additional clarity on some elements of the application of the OEM, particularly; its application to gas fired and mothballed generation, the expected duration of the OEM and which states intend to adopt it.

3.1. Gas generation

The paper contemplates that the OEM will apply to gas fired generation and indicated that as gas fired generation is predominantly peaking cap structures will be more appropriate than swaps. Broadly AFMA agrees with this approach as at this stage most of the gas fired generation operates as peaking plant although we caution that, particularly in South Australia, some gas fired generation operates more like traditional base load or intermediate plant and that swaps may be more appropriate for some plants.

Our larger criticism is that while a mechanism like the OEM is probably appropriate for coal fired generation and older gas baseload units, that are expected to exit the market as a group in the coming years, it is not appropriate for gas peaking generation that is expected to remain a feature of the NEM for many more years and that may require different policy settings to ensure it continues to be available to provide firming capacity.[1] As AFMA has pointed out in a number of submissions we consider that policy attention needs to be given to ensuring that gas fired generation is available to provide necessary firming capacity to support the transition to net-zero.[2]

3.2. Scope of the OEM

The consultation paper describes the OEM as an opt-in framework that is intended to give government the tools necessary to manage the transition to renewables. AFMA would appreciate ECMC providing some clarity about which jurisdictions intend to adopt the framework, as the NEM is an interconnected system and decisions about generation in any given region will have an impact on other regions. Additionally, we would like some clarity about if the OEM is intended to be limited to the transition period or if ECMC intends it to be an ongoing feature of the NEM.

3.3. Treatment of mothballed units

The consultation paper proposes that the OEM could apply to mothballed units but does not provide much detail about how this expected to work. Mothballed units present a slightly different policy problem to units with announced closure dates as while the unit may not be running their operator anticipates that it can be brought back into service when market conditions are appropriate and could potentially expect the unit to operate for an extended period once it returns to service. AFMA would therefor appreciate more clarity about how the OEM will apply to mothballed units, particularly we would like to know if mothballed units, that may not have announced a near term closure date, will be required to close at the end of an OEM contract or if they will have the option to continue operating.

AFMA Recommendations

x.	The OEM should not exclude swaps being available to support base load and intermediate gas fired generation.
xi.	Separate policies should be developed to ensure gas fired generation is available to provide necessary firming capacity to support the transition to net-zero.
xii.	ECMC should clarify which jurisdictions intend to adopt the OEM.

[1] P11 2022 AEMO Integrated System Plan

[2] See for instance the AFMA submission to the Capacity Investment Scheme Consultation Paper

xiii.	ECMC should clarify if they intend OEM to be limited to the transition period or if it to be an ongoing feature of the NEM.
xiv.	ECMC should provide clarity about the application of the OEM to mothballed units.

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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