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March 13, 2018

Dr Kerry Schott AO
Independent Chair
Energy Security Board
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Dear Ms Schott

RE: Energy Security Board National Energy Guarantee Consultation Paper

Australian Industry Group (Ai Group) welcome the opportunity to make a submission on the Energy Security Board's National Energy Guarantee Draft Design Consultation Paper. Ai Group represents thousands of businesses across an expanding range of sectors, from manufacturing to construction, defence, energy, technology, transport, waste and more. While the overwhelming majority of our members are energy users, some of them very intensive, we also benefit from the perspectives of businesses in energy supply chains. The following submission sets out four key messages:

1. Greater climate and energy policy certainty is required to secure the electricity sector investment we need to reduce costs and emissions while maintaining reliability.
2. The final design of the Guarantee must not compromise the competitiveness of our electricity markets.
3. Making provision within the Emissions Obligation to recognise contracts specifying an emissions intensity but not a generation source is essential to retain current liquidity.
4. Making provision within the Reliability Obligation to recognise financial contracts, including caps and swaps, is essential to retain current liquidity.

These and other matters are expanded upon below.



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1. Greater climate and energy policy certainty is required to secure the electricity sector investment we need to reduce costs and emissions while maintaining reliability.

The National Electricity Market (NEM) is in a state of transition. The Australian Government has made a series of international commitments to reduce Australia's greenhouse gas emissions and most of the States and Territories have set even deeper and longer term aspirations. The domestic electricity market is undergoing a rapid transformation due to changing consumer choices and swiftly evolving technology. Against this backdrop of unprecedented change, Australian industry depends on the electricity sector to provide secure and reliable electricity at an affordable price.

Electricity prices have risen sharply following a steep increase in the price of gas and closures of old coal generators that have left gas-fired generators in a more crucial role. New investment is needed to keep the market well supplied and bring on the lowest cost new technologies.

Reliability has also been threatened by recent and looming generation closures, growth in peak demand and the increasing role of variable renewables. New investment is needed in dispatchable generation, energy storage, demand response and geographically diverse renewables.

Emissions in the electricity sector remain far above the shared aspirations of Australians and will be challenged further by increasing demand as other activities like transport electrify to reduce emissions and save money. New investment, reinvestment and responsible retirement decisions are needed to get the sector on track to our long term emissions reduction goals.

However, all of this necessary investment is being held back because for the past decade or so the sector has suffered from the absence of a coherent, well-integrated and durable climate and energy policy framework.

The electricity infrastructure sector has generally comprised of capital intensive assets with high 'sunk costs' and long investment timeframes. Policy certainty is required to ensure that investment in this sector is directed as efficiently as possible to meet the objectives of security, reliability, and emissions reduction, at least cost to consumers. This applies across the electricity system, as the policy framework impacts upon generation, transmission and distribution networks and the environment in which consumers interact with the grid.

Prior attempts at regulating this industry have had limited effectiveness, in part because they have been either short-term in their approach or short-lived in operation. We have had major policy upheaval in energy and climate every few years since 2007. States have moved to provide policy guidance of their own, but these approaches are themselves often politically contested and are in any case uncoordinated and highly variable. This policy uncertainty has limited the market's ability to respond to the price signals from the spot and contracts markets for more dispatchable capacity and inhibited investment in dispatchable power and storage. The Final Report of the Finkel Review highlights this.

The Guarantee aims to integrate energy and climate policy and provide the investment community with the policy certainty it needs to invest in clean, reliable and affordable electricity infrastructure. It is a commendable response from the national market institutions to improve the security, reliability, and affordability of electricity supply, by maintaining an appropriate level of flexible and dispatchable capacity in the electricity system, while contributing to Australia's emissions reduction commitments. The breadth of design options currently on the table entails a lot of uncertainty about how individual energy users may be impacted, particularly those who have already started proactively investing and contracting to reduce their exposure to current extreme market prices. It will be important to narrow down design discussions and bring clarity as soon as possible.

However, the ability of the Guarantee to deliver certainty is only partly a matter of design. Ultimately it will depend also on the broad and sustained consent of Australia's jurisdictions and political parties. A negotiated settlement is needed. This is not just because the legal structure chosen for the Guarantee requires agreement by all NEM States. The past decade has demonstrated that no one side can 'win' and impose a lasting arrangement over the continued objections of their peers. There is no outcome without agreement – and to reach no outcome would be disastrous for the NEM and all of us who depend upon it.



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2. The final design of the Guarantee must not compromise the competitiveness of our electricity markets

Competition is essential if our current electricity market design is to serve the long term interests of consumers. The current state of competition is widely acknowledged to be far from perfect, but a Guarantee design that undermined competition would be unacceptable. The consultation paper acknowledges that the Guarantee must not compromise the competitiveness of electricity markets by entrenching the market power of existing players and creating barriers to entry for smaller players.

We believe that requiring non-vertically integrated retailers to enter into bilateral contracts to meet reliability and emissions obligations may lower liquidity in hedging markets and lead to increased risk-management costs. It may also entrench the market power of vertically integrated entities. The existing high levels of market concentration and vertical integration in the electricity sector can further lead to a market structure which provides opportunities and incentives for the exercise of market power. A competitive supply of energy depends not only on investment in capacity, but also on the ability of diverse retailers to procure sufficient hedge contracts and manage risk.

The Australian Competition and Consumer Commission's preliminary report on retail electricity pricing states that vertical integration provides gentailers (generators/retailers) with a natural hedge against market volatility, thus removing or reducing their need to purchase over-the-counter (OTC) or exchange traded hedging products.¹ This has the direct effect of limiting the pool of potential generation counterparties for retailers to contract with, and/or the volumes of exchange traded product available.² Non-vertically integrated retailers typically protect themselves against risk by entering into financial 'hedge' contracts. A lack of liquidity in risk management markets adversely impacts these retailers in terms of gaining access to competitively priced wholesale electricity and raises barriers to their market entry and expansion.

A recent inquiry undertaken by the House of Representatives Committee on the Environment and Energy recommended that the Australian Energy Regulator (AER) review vertical integration and market concentration in the generation sector to ensure that non-vertically integrated retailers have sufficient access to risk management products.³ The Australian Energy Market Commission's (AEMC) review of retail energy competition indicates that the hedge contract market has been relatively illiquid. Some market participants claim to have been unable to get contracts on reasonable terms. The AEMC also reports that retailers have identified a lack of liquidity in the contract market as a major barrier to entry and expansion.⁴ Retailers believe that the increased cost of hedge contracts has raised the risks and costs to businesses operating in the retail market.

As described further below, we believe there are key design options in the Guarantee that can avoid undermining competition.

¹ Australian Competition & Consumer Commission, *Retail Electricity Pricing Inquiry – Preliminary Report*, Sept 2017, pp 102-103

² Ibid

³ House of Representatives Standing Committee on the Environment and Energy, *Powering our future -Inquiry into modernising Australia's electricity grid*, December 2017, p 119

⁴ Australian Energy Market Commission, *Retail Energy Competition Review*, July 2017, p iv



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3. Making provision within the Emissions Obligation to recognise contracts that specify an emissions intensity but not a generation source is essential to retain current liquidity

Ai Group's members expressed concern earlier in the development of the Guarantee at the risk that the Emissions Obligation might reduce liquidity and competition in the financial markets around electricity. This concern was based on the fear of a situation where every contract was unique (thanks to an embedded link to a specific asset and intensity) and widely used instruments such as futures were no longer fungible.

These fears about the Emissions Obligation would be laid to rest by the option the ESB outlines at 3.3.2 in the discussion paper: recognition of contracts that specify emissions per megawatt hour but do not specify a generation source. While it would be sensible also to recognise the specified-source contracts at 3.3.1 and the default-emissions instruments at 3.3.3, it is essential to the health of the electricity markets that the option proposed at 3.3.2 be adopted. This option would allow for the emergence of contracts that give market participants flexibility to comply with the Obligation while maintaining existing liquid markets in fungible energy instruments. The example given of 'stapled securities' would work well, particularly with scope for unstapling and entirely distinct transactions in energy and other elements of electricity contracting.

4. Making provision within the Reliability Obligation to recognise financial contracts, including caps and swaps is essential to retain current liquidity

Many of our members have expressed concern that the Reliability Obligation could inadvertently damage competition in the electricity markets if it entailed a requirement for bilateral physically linked contracts, which would be highly opaque and illiquid compared to the current markets for swap and cap products.

We believe that these concerns would be largely answered if the final design of the Guarantee recognises exchange traded and over the counter financial contracts, particularly caps and swaps, as considered in section 5.6.1 of the Discussion Paper. These contracts are critical to the current competitiveness of the electricity market and should not be disturbed lightly.

Furthermore, as the Discussion Paper argues, the financial commitments these instruments involve provide a strong incentive for sellers to ensure they have access to physical assets or other means of controlling their risks. Even if these financial contracts were the only means of meeting the Obligation, we would expect the result to be more dispatchable capacity since possession of such capacity will tend to enable parties to sell cheaper more attractive contracts.

It is important that the Obligation not unnecessarily increase administrative burdens on electricity market participants. Allowing use of existing forms of contract can help achieve this objective.

Other ways of satisfying the Obligation might also be appropriate. As long as caps, swaps and comparable financial contracts are qualified without requiring additional demonstration of a physical link, this major concern about the Guarantee will be laid to rest.

5. Other matters – Emissions Obligation

The Emissions Obligation element of the Guarantee is extremely important because it will underpin – or, if poorly designed, undermine – future investment in the electricity system which is necessary to deliver affordability, reliability and emissions reduction. It is essential that the Emissions Obligation enables efficient and competitive behaviour by market participants, minimises transaction and administration costs, is scalable to meet evolving climate ambitions, and provides adequate confidence to investors by achieving broad and durable support from all levels of government and the major parties.

Minimising transaction and administration costs

The proposed registry to underpin 3.3.2 contracts and other transactions must function efficiently. To reduce the burden of reporting requirements, it may be best for the registry to focus on recording transactions directly related to the emissions obligation, rather than wider electricity contracting. This could work as follows:

- Similar to the current proposal, the registry cross references data from the National Electricity Market dispatch engine and the Clean Energy Regulator to generate a log of generation events (by megawatt hour);
- Each generation event entry in the log would have an associated source, emissions intensity, current responsible party, and potentially information on ‘chain of custody’ with previous responsible parties;
- The obligation on retailers would be to ensure that for each compliance year there is a number of generation event entries, marking them as responsible parties, equal to their liable purchases of electricity from the NEM; and that the average emissions intensity associated with these entries is consistent with the target after any flexibility arrangements.
- The initial responsible party marked in the generation event entry would be the original generator;
- Parties transferring responsibility for an event pursuant to their own contractual arrangements would be obliged to advise the registry of this, but not otherwise have to record their wider contract positions;
- Any event entries still ascribed at the time of compliance to generators who are not also listed as retailers could be ascribed (at their average intensity) to any retailers without sufficient entries to cover their liable energy purchases.

This sort of approach should be relatively low cost and provide flexibility to encompass a range of approaches to contracting.

Scalability, adjustability and confidence

The underlying proposed obligation mechanism is conceptually capable, along with the proposed flexibility arrangements, of delivering a wide range of potential emissions reduction ambitions. This is important both because ultimately deeper targets will be needed to deliver Australia’s fair part of a successful international effort to keep global temperature increases to less than 2°C above preindustrial levels, and because to be implemented the mechanism needs to be accepted by States who already have deep emissions or energy commitments. What we have seen so far of the Guarantee gives us confidence that with continued good design and reasonable time frames it can scale to achieve any level of electricity sector emissions reduction asked of it.

There are three problems related to emissions ambition. Firstly, the gaps between the ambition of the Commonwealth, the States and other stakeholders will need to be addressed for the Guarantee to be implemented or to motivate investors.

Secondly, ambition will likely have to evolve and be adjusted over time, and processes for this will presumably be important to reaching a negotiated settlement over the Guarantee as a whole.



Thirdly, the processes by which ambition is amended need to offer sufficient structure and predictability so that they do not undermine investor confidence in the Guarantee.

On the first point, the Commonwealth and the States need to negotiate. The Commonwealth's preferred mechanism cannot be adopted without the unanimous consent of the States. The States' ambitions could be achieved much more efficiently by a single mechanism than by a patchwork of uncoordinated jurisdictional policies.

On the second point, there may be several broad options for bridging or evolving the targets. One would be to allow State targets to be additional within the Guarantee even as their associated mechanisms are replaced. The proposed treatment of Greenpower provides a model for additionality of State targets or mechanisms and their associated projects, and could even allow States to maintain additional targets without using additional mechanisms beyond the Guarantee. Another option would be to elaborate processes in which the States have confidence for review and amendment of the national target trajectory. This could incorporate greater detail about review processes, including elements like an advisory or decision-making body with skills-based members appointed by several jurisdictions, or giving the final decision on targets to COAG rather than the Commonwealth acting alone. A third option would be to articulate two target trajectories – a default consistent with the Commonwealth's initial position and a deeper trajectory consistent with the States' ambitions – together with rules referring to energy price outcomes or other relevant and observable conditions, governing movement between the trajectories. These are worth exploring as the basis for agreement between the Commonwealth and the States.

On the third point, however a deal is achieved and however targets evolve, there are several ways of ensuring that the system still provides guidance and confidence to investors:

- a minimum notice period of five years (as proposed by the Commonwealth, though other periods are possible) for any change to the trajectory;
- a 'speed limit' on trajectory changes, such that the targeted emissions intensity could not change year-to-year by more than a specified amount (say 0.05 t/CO₂e);
- a 'ratchet' such that the trajectory can only be strengthened or paused, not weakened;
- a 'collar' within which the trajectory could move;
- extended but less binding guidance showing a continuation of the initial trajectory over the long term (for a period relevant to long lived power investments, at least two decades out); or
- Enduring and transparent institutions and processes for managing trajectory evolution decisions.

Many of these concepts can be combined – for instance, five years' notice, a ratchet, and an extended guidance period. A ratchet may be particularly important to avoid sovereign risk to investors in new low- or zero-emissions assets. The key outcome is that investors have sufficient confidence to take decisions on investment, reinvestment and disinvestment in typically long-lived electricity assets, while leaving sufficient scope for future adjustment and amendment to meet longer term climate ambitions.

Offsets

The potential inclusion of domestic or international emissions offsets as a means for complying with the Emissions Obligation raises some difficult issues. Ai Group has been, and remains a strong supporter of the use of high quality international offsets by Australia to help ease our transition to lower emissions. Offsets, whether domestic or international, can serve two broad purposes:



1. They can moderate national costs by equalising marginal incentives for abatement between sectors connected by access to or production of offsets. Ideally this drives investment first in those parts of the national or global economy where abatement is most cost effective; and
2. They provide a source of flexibility for obligated businesses to ensure that their own compliance costs are not radically increased by circumstances like forecast error, transient conditions or the market power of other parties.

These are valuable ends in climate policy, though they can be delivered by other means; abatement costs can be moderated through indirect use of offsets or by calibrating the allocation of the abatement task to different sectors; flexibility can be achieved through banking and borrowing and secondary exchanges with other regulated businesses.

However, the National Energy Guarantee is not just an emissions policy – even the Emissions Obligation has another overarching purpose: to provide a firm basis for the investment the electricity system needs to deliver affordable, reliable and clean energy. It would be little consolation if the Guarantee led to, say, high quality reforestation projects in Australia and Indonesia while electricity remained scarce and expensive.

This is a real risk. International offsets and other emissions units currently suffer from fundamental uncertainty. Current Certified Emissions Reduction (CER) units from the United Nations Clean Development Mechanism (CDM) are well understood and largely of high quality, bar certain identified problems with Chinese industrial gas destruction projects. There are very large volumes of CERs available at extremely low prices (typically less than \$1 AUD/tonne), partly because CDM supply over the past decade turned out to be much stronger than expected and demand (especially from Europe) much weaker than expected.

However, CERs are also cheap because there is currently no clarity on whether they will be able to be used to meet post-2020 emissions commitments and obligations. The 2015 Paris Agreement provided at Article 6 for the use of “internationally transferred mitigation outcomes”, but negotiations continue about developing both a new international mechanism and rules to ensure that any exchanges avoid double counting or other pitfalls. At present we have no idea what the post-2020 legal framework will look like, and this will take years more of multilateral diplomacy, into which Australian investors have little insight. We also have no basis for speculating about the volumes of offsets or other units that may be available, or the prices at which they may be sold, which will depend on the domestic emissions policies, economic trends and (based on past experience) forecast errors of many other countries with which Australian investors may be unfamiliar.

Access to international offsets within the National Energy Guarantee would therefore substantially increase the risks that electricity investors must face. Such fundamental uncertainty is antithetical to the investment outcomes that the Guarantee must deliver to be a success. For this reason, Ai Group submits that while these uncertainties abound, the risks of permitting access to international offsets in the National Energy Guarantee are prohibitive.

An exclusion could be reconsidered if and when greater confidence about the international legal framework and related markets develops. Other areas of Australian climate policy, including government purchasing and the Safeguard Mechanism, should be able to make use of international abatement opportunities to help contain Australia’s national abatement costs without causing comparable risks to the energy system.

Domestic Australian offsets raise different issues. Prices and volumes are much better understood. The relevant policy decisions are solely the province of Australian governments, and more readily understood by local investors. The option to use Australian offsets in the Guarantee need not raise the same concerns about uncertainty as international offsets, though whether it does cause problems in practice depends on how well Australian policy-makers perform in delivering clear and credible frameworks. Ai Group submits that Australian offsets should be able to be used for compliance under the National Energy Guarantee, though limits could be considered to contain the potential for contagion from potential future problems in other areas of Australian policy.



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Any limits should be set in concert with decisions about the amount of deferred compliance and carryover that is allowed, and in light of the availability of efficient secondary exchanges between complying parties, to ensure that the total amount of flexibility available is adequate. For all retailers, especially smaller ones, it is important that fluctuations in the customer base or customers' demand from forecasts should not expose them to extreme surges in compliance costs. Limits on flexibility mechanisms are inherently somewhat arbitrary, and should be reviewed and refined over time considering experience of their performance. If possible, changes to offset access should be made with similar notice periods to target changes – though there may be times when change is urgent to preserve scheme integrity.

Emissions Intensive Trade Exposed industries

The potential for climate policies to inadvertently create trade distortions is a long-term concern of Ai Group and our members and should be guarded against. We support the trade neutrality intention behind the proposed exemption of Emissions Intensive Trade Exposed (EITE) activities from the Emissions Obligation, and this may be the best available mechanism to achieve the intention at present. However, we have several points to make.

The first is that the primary and overriding priority is to ensure the National Energy Guarantee helps deliver reliable and clean electricity at the lowest sustainable cost. A wide cross-section of Australian businesses including nearly all of Ai Group's members are exposed to international trade, but relatively few fall within the current EITE definitions. We need to be confident we are achieving a competitive system overall before we concentrate on the allocation of costs within that system. This is particularly so since as proposed the EITE exemption will increase net costs for other energy users. This includes many businesses for which a rise in electricity prices would impose a material burden on competitiveness. These impacts will need to be better understood as an EITE exemption approach is developed.

Secondly, making the exemption fully effective may not be straightforward. The current EITE exemption under the Renewable Energy Target leaves it to energy users to negotiate the value of their exemption with their retailers, and the proposed new exemption would operate similarly. But under the RET, EITEs have access to fairly transparent data about the spot price of the Large-scale Generation Certificates and Small Technology Certificates which retailers use for compliance. Until and unless relevant benchmarks and instruments for secondary exchange emerge, EITEs would be in a weak position of complete reliance on their retailers to realise the full exemption.

Thirdly, the operation of the EITE exemption will need scrutiny, and potentially adjustment, over time. Depending on emissions reduction ambition and other matters the Emissions Obligation could produce gross costs, but these might be accompanied by shifts in spot prices, energy futures or other electricity contracts. If gross costs were larger than net costs, exempting EITEs from gross costs in full could violate Australia's trade commitments under the Agreement on Subsidies and Countervailing Measures (SCM). Annex II (I) (2) of the SCM Agreement provides that:

indirect tax rebate schemes can constitute an export subsidy to the extent that they result in exemption, remission or deferral of prior-stage cumulative indirect taxes in excess of the amount of such taxes actually levied on inputs that are consumed in the production of the exported product.⁵

The operation of the EITE exemption should be monitored to ensure such violations, and any other unintended consequences, are predicted and avoided.

⁵ See https://www.wto.org/english/docs_e/legal_e/24-scm.pdf p264.



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6. Other matters - Reliability Obligation

The Reliability Obligation is important as a backstop to ordinary electricity market behaviour that will ensure sufficient dispatchable capacity is available to ensure adequate reliability. Beyond the critical question of qualifying instruments, Ai Group has comments on several other aspects of the Obligation.

Allocation of liability

There is an important suggestion at section 5.7.4 of the Discussion Paper: that large energy users could be directly responsible for meeting the Reliability Obligation with respect to their own load.

Energy users' first reaction to this is that they would not welcome the additional administrative burden involved in direct liability. However, there is a reasonable argument that energy users will pay these administrative costs anyway, even if it is to a retailer obligated to manage the liability on users' behalf.

Consistent with the Discussion Paper's suggestion, it is imaginable that compliance costs could be reduced by enabling users to apply their own dispatchable capacity or demand response, or that the bankability of dispatchable capacity could be increased by encouraging longer term contracting by commercial and industrial (C&I) customers.

That said, this option needs further examination and consultation if the Guarantee proceeds to detailed design consultation. The benefits of longer term contracting may be more obvious anyway under the Guarantee even without putting the obligation on large users: a retailer that could undertake a dispatchable investment with a longer term C&I contract and achieve lower cost compliance with the Reliability Obligation may be able therefore to offer an attractive price discount on longer contracts. The definition of 'large user' would need to be clarified; does it refer to a facility, a corporate group, or a retail contract? Does it relate to peak load or overall energy demand?

The concept is worth further discussion, though the burden of compliance will have to be minimised (an imperative anyway) before energy users will consider accepting it. A sensible alternative also worth considering would be to allow large users to opt in to manage liability directly, as in the current Renewable Energy Target, rather than applying the obligation to them by default with the potential to transfer the liability. An opt in would be used by those large users with the most ability to manage administration, field dispatchable capacity at low costs, or extract discounts from their retailers in return for long contracts. Users doubtful of their own capability would not be forced to take on excessive burdens.

Process and timeline

The Discussion Paper raises many issues around how and when the various elements of the Reliability Obligation come into play. The following suggestions may make for a more transparent, predictable and low-cost system.

- Open forecasting - ESB proposes to release the forecast methodology, the assumptions, and the draft results. Why not make the underlying model entirely open and available? With an open model, market participants could replicate the results themselves and run their own scenarios.
- Frequency of updates
 - Some assumptions could become outdated at any time - for example if an unanticipated new generation proposal rapidly reaches final investment decision, or an existing asset suffers catastrophic damage. Rapidly reflecting these changes in an updated model output does not increase uncertainty.
 - On the other hand, some official assumptions are more stable and should be updated on a more regular schedule to minimise uncertainty. These include



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economic and demographic growth, the energy intensity of different activities and so on.

- The forecast process could therefore provide a constant 'nowcast' of the current state of relevant assumptions using the announced methodology; update asset assumptions and other relevant volatile matters as they are announced to the market by investors; and update macroeconomic and other more stable assumptions on a regular schedule. Ideally updates to the forecast would be in close to real time as the assumptions change.
- Length of forecast – while a longer horizon in theory promotes more investor confidence, in practice the fallibility of forecasts and the unknowability of critical factors limits the usefulness of further-out projections. If the minimum notice period for changes to the emissions trajectory was five years, and at times there might be only five years of announced emissions targets, reliability forecasts beyond five years might not be very meaningful. The recent history of repeatedly excessive electricity demand forecasts suggests the virtue of focusing on nearer time horizons. Ai Group would suggest five years.
- Trigger timeline – the proposed sequence of forecast, trigger, market response and procurement of last resort makes sense. The following timeline may provide adequate time for each stage while keeping the process near-term and less vulnerable to forecast error:
 - Five year rolling forecast window, which may identify a projected reliability gap;
 - Three-year notice period for generator closures, which may bring forward a reliability gap;
 - Trigger announcement two years from projected reliability gap;
 - Procurement of last resort process begins one year from projected reliability gap, allowing sufficient time for an orderly process that minimises costs.

Ai Group welcomes the ESB's initiative in proposing the Guarantee as a solution to Australia's serious energy and climate policy dysfunction. We look forward to a further opportunity to consult if, as we hope, the COAG Energy Council asks ESB to develop a detailed design consistent with the points above.

Should you wish to discuss this submission further, please contact our adviser Tennant Reed on (03) 9867 0145 or by email at tenant.reed@aigroup.com.au.

Sincerely yours,

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