

What's next for the Renewable Energy Target – resolving Australia's integration of energy and climate change policy?

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Abstract

Australian climate change policy and its integration with Australia's electricity market has been fraught for at least two decades. The only enduring policy has been the Commonwealth Renewable Energy Target (RET). Despite the relative success of the RET in driving investment and reducing emissions, state governments have now pivoted towards Contracts-for-Difference (Cfds). In this article, we outline the issues associated with policy discontinuity and the large-scale RET and review its effectiveness as an emissions reduction tool and driver of electricity sector abatement. We find that the RET has been relatively successful across the key criteria of cost and emissions reductions and is a better policy instrument than Contracts-for-Difference which are increasingly being adopted by state governments. Building on the work of Nelson et al (2020), we propose a new approach which would allow for continued use of Cfds but utilising the RET's policy architecture.

Keywords: electricity market; production subsidy; variable renewable energy
JEL Codes: D04, D47, Q40, Q41, Q48

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1. Introduction

Australia has had a haphazard approach to integration of climate change and energy policy for decades. This is despite Australia having committed to reducing greenhouse gas emissions in a manner consistent with a carbon budget that would limit anthropogenic climate change to no more than two degrees Celsius. The implied carbon budget for Australia to meet this commitment is a 50% reduction on 2005 emission levels by 2030 (Meinshausen et al, 2021) and achieving a 1.5 degrees outcome (which is an aspirational goal of all governments through the United Nations Convention on Climate Change: UNFCCC) would require a 75% reduction. It is worth noting that this is significantly greater than the current Commonwealth Government target of 26-28% by 2030. It can therefore be inferred that greater emission reduction targets in the future are likely, with international pressure likely to 'ratchet up' commitments by the Australian Government.

At the national level, only two policies have materially reduced emissions within the electricity sector: the Clean Energy Future (carbon pricing) package which was introduced on 1 July 2012 but then repealed on 1 July 2014; and the Renewable Energy Target. At the state level, several policies were utilised prior to the Clean Energy Future package superseding them. These included the NSW Greenhouse Gas Abatement Scheme (GGAS) and the Queensland 13% (and subsequently 18%) Gas Scheme. Importantly, governments have tried and failed to agree on a national approach to an emissions intensity scheme through the National Energy Guarantee (Simshauser and Tiernan, 2019).

The Renewable Energy Target is a renewable certificate obligation (ROC) or renewable portfolio standard (RPS) style policy. Energy retailers must buy a set percentage (currently 20%) of their energy from renewable generators.² This is achieved by new renewable projects selling certificates (called large-scale generation certificates, or LGCs) for each unit of production to retailers. This results in new investment in wind, solar, and other green technologies. Policies utilising a ROC style framework have been well studied in markets in Europe and Australia (see Foxson and Pearson, 2007; Wood and Dow, 2010, 2011; Woodman and Mitchell, 2011; and Nelson et al; 2015). Sioshansi (2021, p.3) notes that, 'renewable portfolio standards have long been favoured in the US – as opposed to Feed-in-tariffs or other instruments popular in Europe'.

Despite the enduring success of the RET as Australia's only long-term emissions reduction policy for the electricity sector, the lack of a comprehensive national policy approach to reducing emissions has seen state-governments continue to implement sub-optimal Contract-for-Difference (Cfd) style policies (Nelson and Gilmore, 2021). The Victorian Government has utilised Cfd structures to support new VRE investment through its VRET policy which is aiming at achieving 50% renewable energy by 2030. This has been legislated in the *Renewable Energy (Jobs and Investment) Act 2017 (Vic)*. The ACT has similarly utilised Cfd structures to achieve its goal of 100% of the territory's energy being sourced from renewables. Table 1 provides a breakdown of investment in renewables by scheme driver.

² While the RET includes both the Small-Scale Renewable Energy Scheme (SRES) and the Large-Scale Renewable Energy Target (LRET), this article utilises the RET acronym to refer to only the LRET component of the policy.

Table 1: VRE investment by policy driver

Policy	Total MW underwritten by policy as at June 2021
RET – LRET	16,007 MW
RET – SRES	14,133 MW
VRET	950 MW ³
ACT Auction	Up to 650 MW
QLD 50%	933 MW

As shown in Table 1, Cfds have comparatively driven only a small percentage of renewable energy investment with the vast majority of Australian renewable energy projects banked under the RET (Simshauser and Gilmore, 2020). However, the NSW Government has now legislated one of the world’s most ambitious policies through the NSW Energy Roadmap. Under the *Electricity Infrastructure Investment Act 2020*, the NSW Government has committed to using ‘swaptions’ or long-term energy service agreements (LTSEAs) to underpin 12 GW of new renewable generation in across give new Renewable Energy Zones (REZs).⁴ The plan also involves the use of an underwriting mechanism to deliver ~2 GW of new firming capacity such as battery storage or pumped hydro. It is therefore a critical policy juncture point to assess whether the RET in a moderated form or Cfds are a superior policy choice to drive renewable investment and reduce greenhouse gas emissions.

The NSW Government is responding to market forecasts that over the next 20 years Australia’s ageing baseload coal fleet will be progressively replaced by 30-45 GW of additional utility scale renewable energy capacity (AEMO ISP 2020, p12). It is anticipated that this renewable growth will be facilitated by the parallel development of 15-20 GW of flexible, dispatchable, fast-start firming capacity. Given the high expected levels of variable renewable energy (VRE) penetration, around half of this firming capacity is likely to be ‘medium’ and ‘deep’ energy storage (+4hrs). Technologies likely to be deployed include pumped storage hydro, long duration battery storage and potentially hydrogen fuel cells or turbines.

Given the shortcomings of Cfd style policies being adopted by state governments are well known (see Simshauser, 2019), it is unclear why policy makers have pivoted away from ROC/RPS policies towards Cfds.⁵ The purpose of this paper is to evaluate the effectiveness of the RET in this context and consider how it could be utilised in the future as part of Australia’s policy architecture to reduce emissions cost effectively within the electricity sector. Section 2 provides a brief literature review of analysis of Australian and international renewable energy stimulus and greenhouse abatement policies. Section 3 presents simple quantitative analysis of the RET across the twin objectives of efficient design and emissions reduction. RET policy design adjustments, based upon quantitative analysis of marginal and average abatement, are presented in Section 4 with concluding remarks following in Section 5.

³ 669MW was contracted under VRET auction. An additional 259MW of capacity was added by generators because of government underwriting. ~255MW of solar (3 projects), and ~675MW of wind (3 projects).

⁴ For contrast, peak demand in the entire NSW region is only ~14 GW.

⁵ The existing RET legislation may in fact override the ability of states to create their own certificated schemes, although this has never been tested by Australian courts.

2. Literature Review

The existing literature is heavily skewed towards analysing the use of a broad-based carbon price to reflect the externality cost of producing greenhouse gas emissions. It is almost universally agreed that a well-designed carbon pricing mechanism would be a superior policy choice for reducing emissions (Freebairn, 2020). Studies examining national and international greenhouse gas emissions pricing include: Freebairn (2012, 2014a, 2014b, 2018); Garnaut (2011, 2014, 2015); Holden and Dixon (2018); Quiggin et al. (2014); Wood and Blowers (2016); Naughten (2013); The Climate Institute (2013); Kember et al. (2013); and Clarke (2011). Many of these studies are quantitative in nature and conclusions have been built upon through the use of Computable General Equilibrium (CGE) modelling. These include Adams (2007, 2013, 2014) and Meng et al. (2013). In particular, McKibbin, Wilcoxon and their colleagues have published multiple studies since the 1990s (see for example, McKibbin et al. 2002a, 2002b, 2009, 2012, and 2014; Pearce and McKibbin, 2007).⁶

However, despite the theoretical and applied literature demonstrating a well designed emissions trading scheme should be adopted, most of the political debate is fixed on the future of coal and gas within the real economy in Australia. Sadly, this completely misrepresents the real risks to the Australian economy (Nelson, 2015). Australia is one of the world's largest energy exporters. Coal (14.8%) and gas (10.6%) comprise around one-quarter of Australian exports. Australia is the largest exporter of coal with around 30% of all total coal exports and has recently overtaken Qatar as the world's largest exporter of LNG. In this context, it matters little what Australian politicians think the future of gas and coal looks like. What matters are the views of Australia's largest energy trading importers such as Japan, Taiwan, China and Korea. All of these countries have committed to net zero and are shifting consumption away from Australia's fossil fuel exports. The sad outworking of this situation is that, 'According to the 2020 Climate Change Performance Index, Australia was ranked as the worst-performing country on climate change policy (Ali et al, 2020).

The cost of uncertainty and the 'merit-order effect'

Given the fraught political debate about the future of coal and gas in the Australian economy, there has been ongoing policy discontinuity in relation to energy and climate change (see Simshauser and Tiernan, 2019). The costs of this ongoing policy uncertainty have been well documented in the Australian literature (see Nelson et al, 2010, 2012; Byrnes et al., 2013; Jones, 2010, 2014; Nelson, 2015). Many of these studies note that in a capital intensive industry such as electricity, a lack of certainty in relation to public policy results in sub-optimal capital investment. Over time, this manifests in higher than necessary electricity costs driven by a higher weighted average cost of capital (WACC) and an industry preference to minimise capital at risk by deploying higher operating cost technologies (see Nelson et al, 2011; Nelson et al, 2014).

Simshauser and Gilmore (2020) provide a very useful overview of the 'rate of change' problem whereby significant additional costs have been imposed on the Australian economy due to Australia's policy incoherence. Ongoing policy changes resulted in an 'investment megacycle' whereby ~12,000MW of plant commitments comprising \$20+

⁶ Both McKibbin (in general) and Nelson (2015) make the point that mitigation impacts on Australia are likely to be mostly incurred through other countries shifting their energy mix away from coal and gas, two large sources of export revenue.

billion across 105 projects – most of them Variable Renewables’ was squeezed into just three years (2017 to 2020).⁷ Unsurprisingly, there were significant connection delays and major issues with system Frequency operating outside normal bands, critical reductions in system strength and increasing interventions by the market operator to keep the system secure. Instead of focusing on these important engineering issues, the policy debate shifted towards market redesign proposals with a focus on future reliability and resource adequacy. Sadly, very little of the debate was grounded in an understanding of the problem (see Nelson et al., 2018).

Renewable energy certificate schemes

As noted earlier, ROC style policies have been well studied in markets in Europe and Australia (see Foxson and Pearson, 2007; Wood and Dow, 2010, 2011; Woodman and Mitchell, 2011; and Nelson et al.; 2015). Sioshansi (2021, p.3) notes that, ‘renewable portfolio standards have long been favoured in the US – as opposed to Feed-in-tariffs or other instruments popular in Europe’.

The main limitation of mechanisms such as the RET is that they are not technology neutral. While they are a better policy design than general subsidies, they overlook opportunities for abatement (e.g. energy efficiency) because of their focus on new investment in production capacity (Freebairn, 2018). While mechanisms that subsidise new investment can lower wholesale electricity prices in the short run (assuming the absence of existing generator retirements) (Bell et al., 2017), the policy can have the perverse effect of stimulating electricity consumption beyond efficient levels (Freebairn, 2018). Critically, the ‘merit-order effect’ of lower prices is temporary. Wholesale prices will rise to the long-run average cost (LRAC) of the efficient new generation mix (see Nelson et al., 2018). Importantly, quantitative modelling has demonstrated that LRET style mechanisms have higher abatement costs than well designed emissions tax and trading mechanisms (Buckman and Diesendorf, 2010). In short, most of the literature around LRET style policies finds that they are inferior to a well-designed emissions trading scheme (see Nelson et al., 2019).

There are also significant benefits associated with ROC-style policies such as the LRET. In the Australian context, the LRET has resulted in significant additional investment, particularly in new wind generation (Cludius et al, 2014). Bell et al. (2017) found that the LRET has lowered wholesale spot prices through reductions in technology costs. Rather than the overarching policy mechanism, design flaws of LRET in its implementation in a market with significant retail and generator concentration may have contributed to sub-optimal outcomes (see for example Simshauser and Tiernan, 2019; Buckman and Diesendorf, 2010). Furthermore, the ongoing review and amendment of the LRET and continuing disagreement between the Commonwealth and state governments is likely to have had a detrimental impact on its cost-effectiveness (see Jones, 2010, 2014).

⁷ For contrast, the NEM’s entire capacity is ~50 GW.

Contracts-for-difference schemes

Cfds are relatively simple in structure. Governments hold reverse auctions for capacity and award Cfds to the winning proponents of new generation. The Cfd structure generally involves a 'strike price' which is compared to the wholesale spot price in each settlement period. Where the wholesale price is lower than the strike price, the government pays the proponent the difference. If the wholesale price is higher than the strike price, the generator pays the government the difference.

While it is true that CfDs may reduce risks to individual project proponents from a LRET floating LGC price (Woodman and Mitchell, 2011), Bunn and Yusupov (2015) demonstrate that with negative correlation between renewable output and wholesale electricity prices, LGCs reduce investment risk when compared to Cfds or feed-in tariffs (FITs).

There are obvious problems with utilising Cfds. Governments effectively 'become the market' and determine which generator investments proceed. Electricity markets are incredibly dynamic and investments need to consider not just the Levelised Cost of Electricity (LCOE) but the spatial and temporal dynamics of market pricing. Building very low-cost generators with very high renewable resources in congested and weak parts of the grid has resulted in very poor outcomes in Victoria's north-east (see Simshauser and Gilmore, 2020). Furthermore, it is naïve to assume governments are well placed to decide which investments are likely to be economic due to the need to assess a project's production against a dynamic market with significant changes in demand across the day and season. In fact, one of the strengths of utilising a market approach rather than a Cfd is that poor investments result in the project proponent (rather than the government) writing down their investment with consumers benefiting.

Simshauser (2019) notes that there are three inherent limitations associated with Cfds:

- Government-initiated Cfds are usually awarded on simplified metrics such as minimising the levelized cost of energy (LCOE). As noted above, ignoring temporal and spatial dynamics is likely to introduce inefficient plant entry. In contrast, well-designed renewable portfolio standards such as the LRET require investors in generation to determine not just costs but the spatial and temporal dynamics of the project relative to the market.
- Importantly, Cfds introduce a new category of 'quasi-market' participant that is completely removed from the market's locational, spot and forward pricing signals. Over time, this results in sub-optimal decision making within the dispatch of energy and enhances the risks to secure and reliable system operation.
- The use of Cfds results in these new 'quasi-market' participants withdrawing from primary issuance forward derivative hedge markets. Given the certainty of revenue due to the Cfd, there is little incentive for these new generators to manage price risk using financial derivative contracts. Over time, the government effectively becomes the market. Efficient pricing, retail competition and innovation are likely to be stifled as new participants are unable to compete.

One of the overlooked aspects of Cfds in the Australian context is the impact of shifting policy support to an alternative mechanism despite the significant investment made to date under a long-term enduring policy. The RET has delivered over 16 GW of new investment which is underpinned by the market value of wholesale electricity prices and LGCs. By shifting towards Cfds, governments are effectively stranding investments and effectively transferring existing renewable proponent producer surplus to consumer

surplus and new entrants with the potential for issues related to refinancing and 'toxic debt' (see Simshauser and Nelson, 2012; Nelson et al 2013). Our analysis and policy recommendations in subsequent sections considers ways in which Cfds could be modified to minimise these impacts.

Advocates of Cfds generally use two arguments that are flawed in our opinion: reductions in the weighted average cost of capital; and the 'merit-order effect'. Given the significant exposure of existing debt and equity participants to the 16 GW of projects already built under the RET (with much of it being refinanced in 2022 and 2023), project proponents will likely face higher WACCs as a result of the erosion in value of their projects due to the switch from one form of policy support (RET) to another (Cfds) – see Simshauser and Gilmore (2020) for further analysis on this topic.

The 'merit order effect' has been promoted as a reason for introducing both ROC and Cfd style policies. The phenomenon is well documented in the academic literature, with studies originating from around 2008. The earliest studies focused on economic impacts of introducing very low short-run marginal cost technologies such as variable renewables (Sensfuss, Ragwitz and Genoese, 2008; Poyry, 2009; Pirnia, Nathwani and Fuller, 2011; Gelabert, Labandeira and Linares, 2011). Australian studies have also examined the phenomenon. Many studies have considered the impacts on the NEM price duration curve (see MacGill, 2010; Forrest & MacGill, 2013; Cludius *et al.*, 2014; Bell *et al.*, 2017) and the impact of coincident production on specific price bands.

However, as Nelson et al (2011, 2012) and Simshauser (2019) note, the merit order effect is a transitory phenomenon. Prices must return to levels that allow for fixed and operating costs to be recovered or plant is permanently withdrawn, resulting in significant intra and inter period pricing volatility (see Nelson et al, 2018). This is an important observation given one of the purported benefits of the NSW Energy Roadmap is permanently lower wholesale electricity prices.

Emerging literature on policy evolution

A defining feature of good public policy is the creation of a uniform value of abatement. This allows for the lowest cost abatement to be pursued first (Freebairn, 2020). It is therefore worth considering whether the RET can be 'evolved' to better align with this principle by creating fungibility with other forms of abatement in Australia such as Australian Carbon Credit Units (ACCUs). This is something that was explored by Nelson, Rai and Esplin (2021) who proposed tying economic value from ROC, Cfd or PFIT policies to either emissions intensity or wholesale electricity prices.

Our analysis in the proceeding sections considers this issue. In particular, we find that the worst impacts of Cfd can be overcome if they are written against the LGC (rather than the wholesale price). This ensures that market participants continue to face the spatial and temporal dynamics associated with locating and operating in the NEM. This can also allow for integration of Cfd policies within a broader carbon framework due to the assignment of carbon abatement to LGCs through an emissions 'exchange rate'.

3. Assessment of the RET against multi-faceted criteria

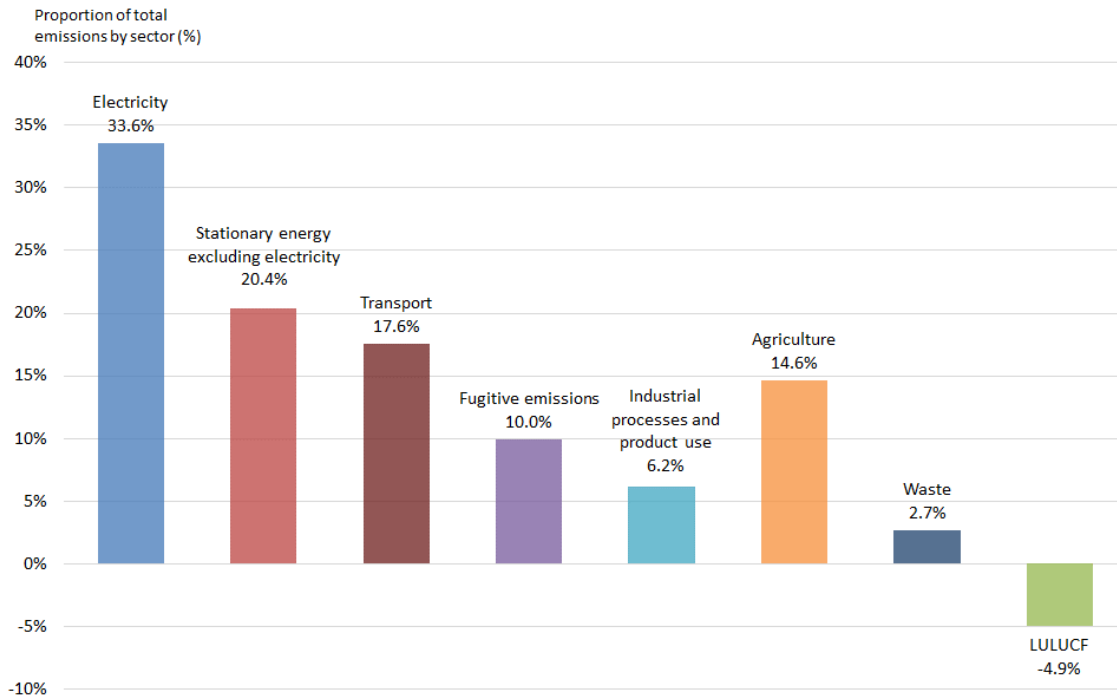
In this Section, we evaluate the RET against qualitative and quantitative criteria: emissions abatement; price and cost effectiveness; and economic development. The purpose of our analysis is to determine whether the RET has been successful as a

means of providing a sustainable framework for cost effective emissions reductions within the electricity sector.

Emissions Abatement

Australia currently produces around 500 million tonnes (mt) of greenhouse emissions (carbon dioxide equivalent: CO₂e) each year. The sectoral breakdown of emissions is shown in Figure 1 below.

Figure 1: Australian greenhouse gas emissions by sector

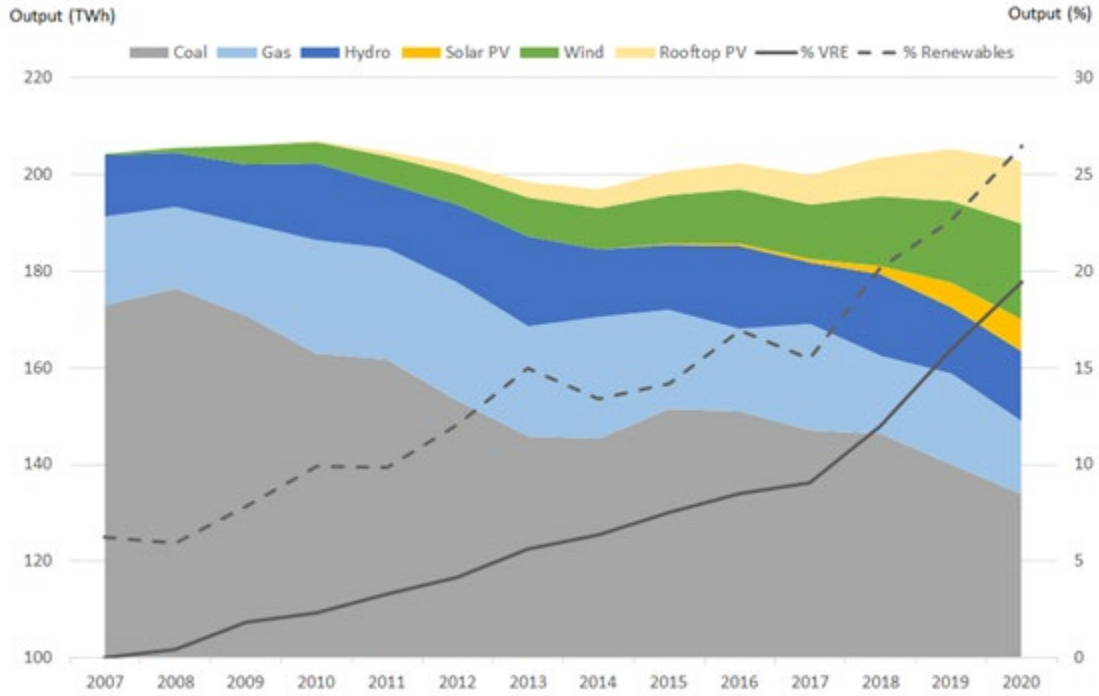


Source: Australian Greenhouse Accounts

Figure 1 shows that the stationary energy sector (including electricity) produces around half of all greenhouse emissions. Electricity is the largest single point source of emissions with around one-third of total Australian emissions. However, it is also a relatively low-cost source of abatement with the potential for further technology evolution and deployment into other sectors through electrification (e.g. transport and stationary energy processes). Given these dynamics, it is not surprising that the electricity sector has been the focus of policy makers through the RET and now emerging CfD policies in the ACT, Victoria and NSW.

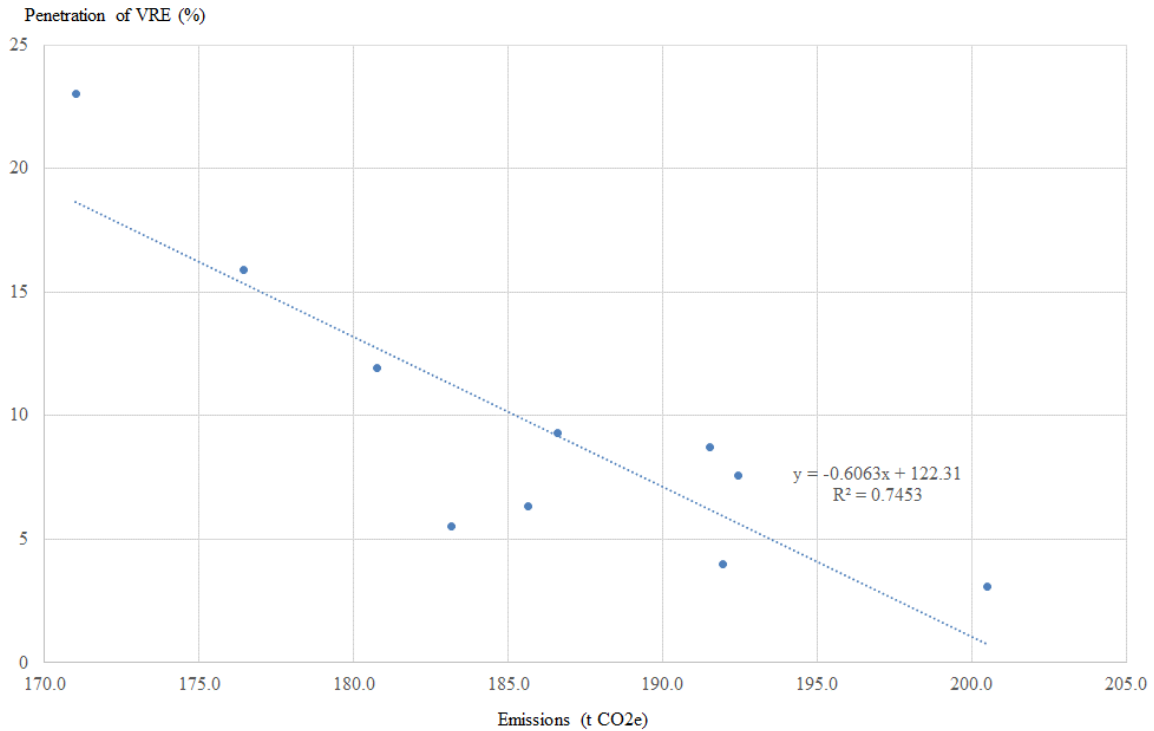
Figure 2 shows the impact of electricity sector policies on generation output in the NEM over the past decade. As uncertainty around the investment trajectory required by the RET was removed following the Warburton Review in 2014 (see Nelson et al, 2015), an investment megacycle occurred between 2017 and 2020 (recall Table 1). The share of variable renewables (VRE) climbed rapidly to around 20% in 2020. Almost all this investment utilised LGCs as part of project economics and financing.

Figure 2: NEM output by technology



Source: opennem.org

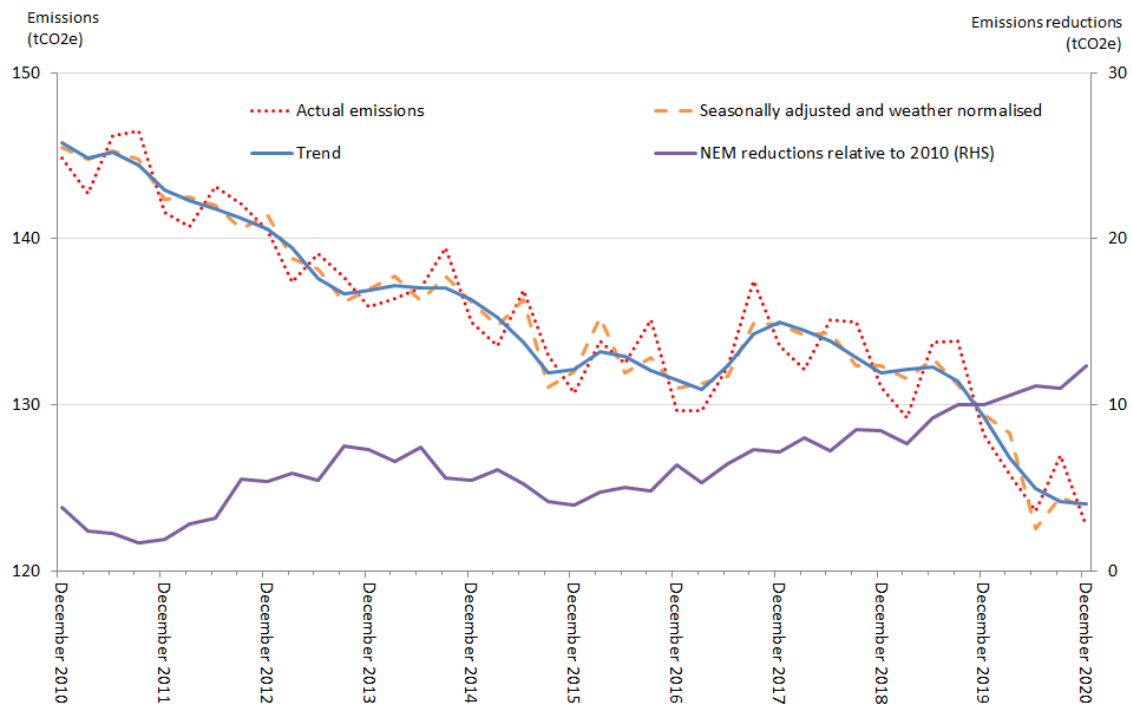
Figure 3: Correlation between penetration of VRE and sectoral emissions



Source: Produced using data from opennem.org and Australian Greenhouse Accounts

Figure 3 shows the strong correlation between the penetration of VRE and electricity sector emissions in recent years. As new renewables have entered the system, existing and ageing coal assets have been retired. In fact, around one-third of Australia’s coal-fired power stations closed in the 2010s as a consequence of renewables entering the system (Burke et al, 2018). The substitution of these relatively high emitting assets with renewables has reduced NEM emissions by around 15%. Importantly, the contribution of electricity sectoral emission reductions to the overall Australian inventory has been significant. This is shown in Figure 4.

Figure 4: Quarterly Australia-wide emissions trends and NEM emission reductions



Source: Produced using data from Australian Greenhouse Accounts

Figure 4 demonstrates that the RET has done much of the heavy lifting in relation to Australian emissions reductions. Quarterly total emissions have decreased from ~145mt in 2010 to around ~125mt in 2020. Of this ~20mt reduction in quarterly emissions, the RET (through technology substitution in the NEM) has delivered around 60% or ~12mt per quarter. This is a non-trivial finding. Of all the policies introduced to reduce emissions (QLD 18% Gas Scheme, NSW GGAS, Clean Energy Future, Emission Reduction Fund and Safeguard Mechanism), a single policy is contributing more than 60% of the emissions reductions that are being sustainably achieved. As a policy instrument, the RET has been very successful in reducing emissions. And it is continuing to provide the underlying policy architecture for additional reductions through voluntary purchases by corporate customers and households (via GreenPower).⁸

Pricing and economic effectiveness

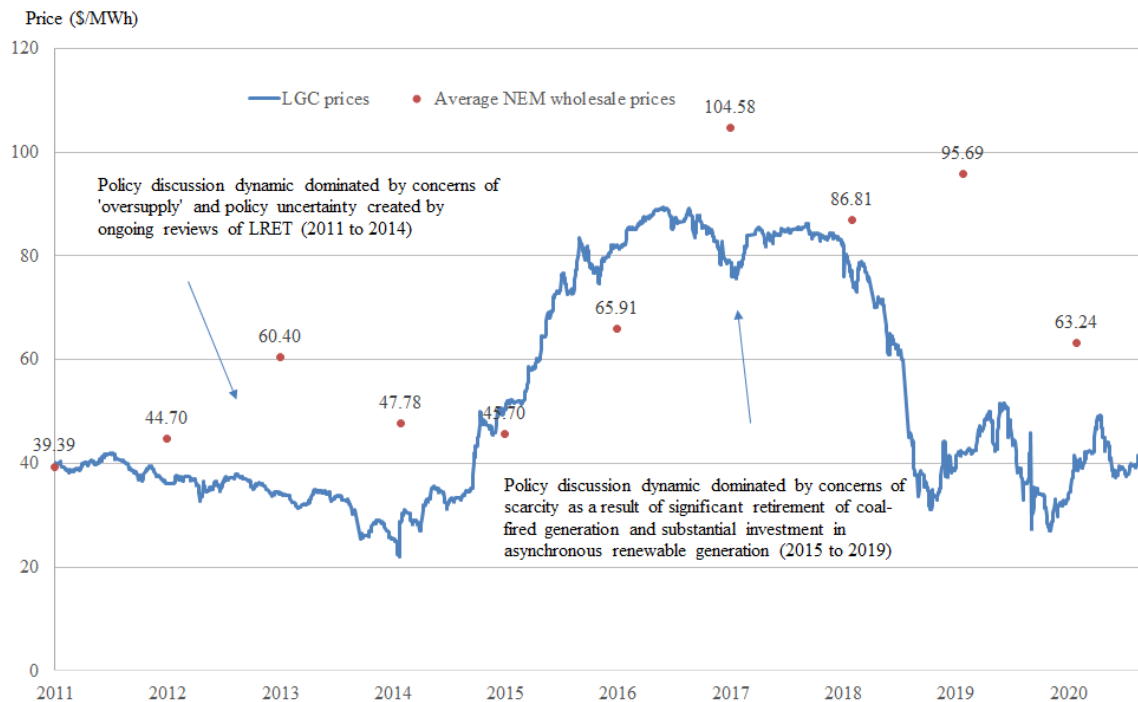
Electricity pricing has been a politically charged topic in Australia following the closure of the Hazelwood power station and a rapid run up in wholesale electricity prices in 2017 and 2018. Since 2011, the general Consumer Price Index (CPI) rose by around 2% pa while the electricity component of the CPI rose by around 3.5% pa. Much of this is

⁸ As at June 2021, there are around 3 GW of new large-scale renewable projects at various stages of commissioning and construction.

explained by inefficient increases in network spending and a rise in new entrant costs for wholesale markets. Simshauser and Gilmore (2020) note that the NEM's history of new entrant cost is comprised of four separate and distinct time periods. Up until 2011, the NEM was characterised by new-entrant costs of between \$40/MWh and \$60/MWh with the dominant technology shifting from coal to gas in the mid-2000s. Between 2011 and 2015, the NEM new entrant cost increased further to between \$60-80/MWh for a combined cycle gas turbine (CCGT) as higher gas prices manifested because of east-coast gas demand tripling due to the emergence of LNG exports. Since 2015, the new entrant cost has approximated \$70-80/MWh as firmed wind has emerged as the technology of choice.⁹¹⁰

It should be noted that the upward trend in new entrant cost is not simply a function of the RET. Input fuel costs for thermal plant have increased significantly over the past decade as both coal and gas markets became increasingly export exposed. In the case of coal, \$AUD pricing increased from ~\$50/tonne in 2005 to ~\$100-150/tonne over the past decade. Assuming a heat rate of 9 to 10GJ/MWh, the implied short-run marginal fuel cost has increased from \$25/MWh up to as high as \$65/MWh. Similarly, gas prices increased materially from a historical cost-plus model of around \$3-4/GJ to LNG export netback prices of up to \$15/GJ. Given this significant variability in fuel cost, it is unsurprising that the benchmark new entrant cost has become firmed renewables.

Figure 5: LGC and average NEM wholesale prices



Source: Compiled from industry data

Figure 5 shows that the Australian NEM and RET are classic commodity markets. There is both intra and inter period volatility within the NEM, representing lumpy capital

⁹ Firmed wind is effectively the cost of a MWh of wind added to the cost of a \$300 cap contract (which reflects the fixed cost of a gas-turbine). In this way, the MWh of wind becomes 'firmed' by the gas turbine and is equivalent to a MWh from a high-capacity factor thermal plant.

¹⁰ Some market participants have announced Power Purchase Agreements (PPAs) well below these new entrant costs. This is due to the emergence of 'two-step pricing' whereby participants allocate low returns to equity in the short to medium term with a view that significant returns will emerge in the future due to higher pricing. This business model is unlikely to be sustainable.

investment and withdrawal and short-term spatial and temporal constraints (see Nelson et al, 2018). When annual averages are considered, prices reflect market imbalances and are generally mean reverting (like any commodity market).

However, policy discontinuity also played a significant role in the market dynamics observed in Figure 5. Between 2013 and 2015, the Commonwealth Government repealed Australia’s national carbon pricing framework and commissioned a debilitating review of the RET. During this period, renewable investment stalled as market participants faced lower prices due to oversupply, lower LGC prices due to concerns the Government was predisposed to repealing the RET legislation and waited for the outcomes of the Government’s deliberations. With a revised trajectory settled in 2014/15, LGC prices rapidly recovered and existing coal fired power stations continued to withdraw from the market driving wholesale electricity prices higher.

To assess the RET’s effectiveness in sustainably driving new investment (despite the uncertainty discussed above), we have reconstructed the economics of a ‘typical’ wind project in South Australia developed in each year between 2011 and 2020. South Australia has been selected given the significant deployment of renewables over the past decade (largely due to the region’s superior wind speeds). Capital costs, fixed and operating costs, and financing costs have been sourced from Simshauser and Gilmore (2020). The levelised cost of energy (LCOE) in each year is determined using the following formula.

$$LCOE = \frac{Capex \times CRF + FOM}{(8760 * CF)} + VOM$$

Where capex = overnight capital cost (\$/kW)

FOM = fixed operating and maintenance costs (\$/kW)

CF = capacity factor (%)

VOM = variable operating and maintenance costs (\$/KWh)

CRF = capital recovery factor

The capital recovery factor is determined using the following formula:

$$CRF = \frac{\{WACC(1 + WACC)^t\}}{\{(1 + WACC)^t - 1\}}$$

Where t is the number of time periods

WACC is the weighted average cost of capital which is determined using the following formula:

$$WACC = r_d * Debt\ share + (r_e * (1 - debt\ share))$$

Where r_d and r_e represent the returns to debt and equity respectively and the debt share is the proportion of total funding that is debt (as opposed to equity).

Key input assumptions for deriving the LCOE in each year between 2011 and 2020 are presented in Table 2. The proportion of funding from debt and equity has been set at 50% in each year.

Table 2: Key input assumptions for LCOE calculations

Year	Capex (\$/kW)	O&M (\$m//KW/a)	VOM (\$/MWh)	Equity (%)	Debt (%)
2011	2,343	39	2.61	12	8
2012	2,711	40	2.66	12	7
2013	2,088	41	2.72	12	7
2014	2,325	42	2.77	12	6
2015	2,325	43	2.83	12	5
2016	2,485	43	2.88	12	5
2017	2,114	44	2.94	10	4
2018	1,930	45	3.0	10	4
2019	1,855	46	3.06	10	4
2020	2,049	47	3.12	10	4

Source: Adapted from Simshauser and Gilmore (2020)

Having derived an LCOE for each year from 2011 and 2012 for a ‘typical’ wind project in the Australian market, we are then able to determine whether the LCOE is recovered from electricity and LGC revenue. The total revenue in each year is the aggregate wind profile dispatch weighted average (DWA) price for the year added to the average annual LGC price per MWh generated. The net revenue in each year is therefore:

$$Net\ Revenue_t = DWA_t + LGC_t - LCOE_{construction\ year}$$

Two sets of results are presented in Table 3 and Table 4 respectively. Table 3 shows the net annual revenue for 1 MWh of ‘typical’ South Australian wind farms built in each year from 2011 to 2020. Table 4 provides the same analysis but with only the electricity revenue (and not the LGC revenue) included in the calculations.

Our results demonstrate the variability in cashflows and profitability for merchant assets in an energy-only gross pool market. Wind farms built between 2011 and 2015 experienced losses during these years but significant profitability because of the tight supply/demand balance that prevailed between 2016 and 2018. As the market cycle swung back into oversupply in 2019 and 2020, all the projects built across all years (including 2020) once again experienced negative profitability. In total, 21 of the 55 annual profitability results provided in Table 3 are negative. This is an important feature of the RET’s policy design. Consumers benefit from market participants overbuilding (and facilitating oversupply) through lower prices.

Table 3: Net Revenue by year for ‘typical’ South Australian wind farms built in each year from 2011 to 2020 (including LGC revenue)¹¹

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
LCOE	101.76	111.74	87.14	92.41	89.76	92.32	73.74	69.24	67.61	73.13
Elec	29.12	39.95	65.80	39.94	38.22	60.13	97.59	78.89	70.41	29.39
LGC	39.17	35.66	34.07	30.46	55.39	82.3	83.24	74.33	42.53	35.43
Revenue by Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
2011	-33.47	-26.15	-1.89	-31.36	-8.15	40.67	79.07	51.46	11.18	-36.94
2012		-36.13	-11.87	-41.34	-18.13	30.69	69.09	41.48	1.20	-46.92
2013			12.73	-16.74	6.47	55.29	93.69	66.08	25.80	-22.32
2014				-22.01	1.20	50.02	88.42	60.81	20.53	-27.59
2015					3.85	52.67	91.07	63.46	23.18	-24.94
2016						50.11	88.51	60.90	20.62	-27.50
2017							107.09	79.48	39.20	-8.92
2018								83.98	43.70	-4.42
2019									45.33	-2.79
2020										-8.31

¹¹ Our analysis has been engineered to be deliberately conservative by using real LCOEs (\$2020) but unadjusted revenues.

Table 4: Net Revenue by year for ‘typical’ South Australian wind farms built in each year from 2011 to 2020 (excluding LGC revenue)¹²

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
LCOE	101.76	111.74	87.14	92.41	89.76	92.32	73.74	69.24	67.61	73.13
Elec	29.12	39.95	65.80	39.94	38.22	60.13	97.59	78.89	70.41	29.39
LGC	39.17	35.66	34.07	30.46	55.39	82.3	83.24	74.33	42.53	35.43
Revenue by Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
2011	-72.64	-61.81	-35.96	-61.82	-63.54	-41.63	-4.17	-22.87	-31.35	-72.37
2012		-71.79	-45.94	-71.80	-73.52	-51.61	-14.15	-32.85	-41.33	-82.35
2013			-21.34	-47.20	-48.92	-27.01	10.45	-8.25	-16.73	-57.75
2014				-52.47	-54.19	-32.28	5.18	-13.52	-22.00	-63.02
2015					-51.54	-29.63	7.83	-10.87	-19.35	-60.37
2016						-32.19	5.27	-13.43	-21.91	-62.93
2017							23.85	5.15	-3.33	-44.35
2018								9.65	1.17	-39.85
2019									2.80	-38.22
2020										-43.74

¹² Our analysis has been engineered to be deliberately conservative by using real LCOEs (\$2020) but unadjusted revenues.

However, if the LGC revenue is removed (as shown in Table 4), then the total number of years in which a negative economic outcome is recorded increases to 46 (out of the total 55 years). This has non-trivial implications for policy design which we will explore in further detail in the subsequent section. Put simply, utilisation of policy frameworks that only utilise the wholesale electricity price are likely to create a significant exposure for governments (and taxpayers) or energy consumers due to prolonged policy-induced periods of oversupply driving the out-of-market subsidy higher. If this is not the case, then CfD style frameworks are likely to accentuate the boom/bust nature of wholesale electricity prices resulting in poorer outcomes for consumers.¹³ At the very least, the RET has not removed the incentive for participants to manage the temporal and spatial risks associated with operating in the wholesale electricity market. A renewable resource with a poor correlation to demand and price is penalised relative to a project that optimises location and resource to deliver energy where and when customers require it.

Economic development

Simshauser and Gilmore (2020) note that the total investments made under the RET in the period following the debilitating Warburton Review total 105 projects comprising \$20 billion of investment in just a few short years. While beyond the scope of this article, it is worth noting what other studies have found in relation to the contribution of the RET to economic development and employment. Studies have found that every \$1million invested in VRE facilitates 4.8 full-time jobs in infrastructure development. This has been contrasted with fossil fuels investments which are found to underpin only 1.7 full-time jobs (EY, 2020).

Importantly, much of the investment in renewable projects under the RET has provided significant stimulus to regional Australia. Based upon standard investment practice of ~\$10k per turbine per project to landholders per annum, the total injection to landholders is likely to total ~\$30-50 million p.a. out to 2050.

4. Policy recommendations: integrating CfD frameworks using the RET

The RET required investment in renewable energy generation equivalent to the annual production of 33 TWh by 2020. At the time of writing, this objective has been achieved. Discussion about the future of the RET has largely been muted given the focus by state governments on developing CfD policies to deliver climate change objectives. There are two observations from our analysis of the RET in the preceding Section which are worth noting in this context:

Finding 1: the RET facilitated *both* positive and negative years of cashflow (relative to underlying LCOE). In other words, consumers benefited from overinvestment through lower prices (relative to LCOE) and *all* project proponents were required to address the risks associated with the NEM's spatial and temporal dynamics.

Finding 2: Without LGC revenue, all projects would have experienced negative income (relative to LCOE) almost all of the time. This has non-trivial implications for policy design. CfD style policies would have resulted in much lower wholesale electricity prices to compensate for lost LGC revenue. But governments could have been exposed to

¹³ This is particularly relevant for large energy-intensive trade exposed industry which cannot be shielded from higher energy costs in the same way that they are under the RET (through an LGC surrender exemption).

significant 'out of the money' Cfd liabilities of ~\$0.25 billion in South Australia alone.¹⁴ In other words, all producers would have been guaranteed to make a return on their investment: privatising profits and socialising losses.

Policy proposition 1 – utilising the RET architecture to implement Cfd policies

As noted earlier in this article, state governments are adopting ambitious policies to decarbonise electricity grids between 2020 and 2030. The NSW Government has a 12 GW 'swaption' Cfd policy and the Victorian Government intends to utilise Cfds to achieve 50% VRE by 2030. This article provides insights into how these governments could modify their policy frameworks to achieve these goals while limiting the most negative impacts of Cfds. Section 2 demonstrated that two limitations in particular require particular attention by policy makers: by underwriting projects through the wholesale price, governments effectively remove the need for market participants to efficiently locate and operate their projects to maximise value given spatial and temporal dynamics; and governments effectively underwrite all the new projects in the market.

Both limitations could be overcome by writing the Cfd or swaption on LGCs created through the RET policy architecture. By entering into a Cfd (or swaption) for the government to acquire and voluntarily surrender the LGCs, market participants would still be required to locate and operate their project efficiently within the wholesale electricity market to maximise value.¹⁵ Market participants would be required to carefully consider location (to avoid issues related to reductions in dynamic marginal loss factors: MLFs) and forward hedging of output to minimise exposure to volatile spot pricing. Consumers would benefit from increased liquidity and transparency in the short-term and lower sustainable prices in the long-term as more efficient projects are built and market participants (rather than governments and/or consumers) face the risk of lower returns due to poor project performance.

The 'spread' of potential price outcomes for LGCs is likely to be lower than wholesale electricity prices. Assuming current forward market pricing (see Attachment 1), governments could sell put rights to LGCs for a strike of ~\$20/LGC. As such, the maximum exposure in any year for each MWh would be \$20, although it is unlikely that LGCs would be worth nothing (particularly given the proceeding discussion in this Article about carbon fungibility). This is a significantly better outcome than the average out of the market payment (\$56/MWh) that would have been made in 2020 if projects built under the RET were receiving Cfds.

'Swaptions' rather than generic Cfds should be pursued by governments as a means of incentivising the engagement of voluntary buyers of LGCs. This would minimise the exposure of governments (and consumers if out of market payments are to be recovered through distribution charges) to growing financial liabilities. Demand for LGCs by businesses within Australia continues to grow with many companies committing to 'science-based targets' and aligning their operations and strategy to meet emission reduction targets implied by the Paris agreement. Companies are increasingly aware of

¹⁴ This approximate calculation is based upon total MWh produced by wind in South Australia in 2020 being exposed to the negative economic outcomes in Table 4.

¹⁵ This could include trading off total volume (and potentially a higher LCOE) for additional value, allowing developers to value projects that better match load, are uncorrelated with other renewable projects, or includes storage that shifts production to higher value periods.

the need to address climate risk within their operations and the implications for company directors to discharge of their duties under corporate law.¹⁶

The Commonwealth Government is reforming reporting under the *National Greenhouse and Energy Reporting Act* to create greater transparency around how companies in Australia are claiming to be ‘renewable’ or ‘carbon neutral’.¹⁷ It is very likely that governments and investors will require companies to voluntarily surrender LGCs equal to their electricity use to be able to claim that they are using 100% renewable energy. The Government is instituting these reforms given the significant voluntary action already being undertaken by corporates in Australia. For example, 22 of the largest companies in Australia have formed a ‘Climate Leaders Coalition’ and many of Australia’s largest emitters and electricity users are part of the Climate Active program established by the Commonwealth Government.¹⁸

By utilising swaptions for LGCs, governments can effectively underwrite new investment while minimising their own financial exposure and maximising incentives for market participants to locate and operate their projects efficiently and find customers for the imbued greenhouse emissions abatement in their operation. No reforms of the existing RET policy architecture would be required. The Commonwealth and states could continue to have differing views on the pace of decarbonisation but the framework underpinning new investment in the electricity sector would be nationally consistent.

Policy proposition 2 - Carbon fungibility and development of ‘green hydrogen’

Another key consideration of policy makers in relation to the future of the RET is its alignment or ‘fungibility’ with other carbon reduction instruments in Australia. While LGCs surrendered for compliance purposes under the RET are obviously not ‘additional’, all other LGCs are reducing emissions beyond legislated targets. Substitution of existing emissions intensive generation with new renewables will only occur if: voluntary action is taken to purchase renewable energy beyond what it is required by the market; governments mandate new additional VRE investment through Cfds or ‘swaptions’; and/or existing thermal generation is retired at its end-of-life and new renewables investment occurs to fill the gap created by generator exit.

The first two scenarios described above are clearly *additional*. Additional abatement is occurring because of voluntary market activity over and above what would occur through business-as-usual. It is therefore worth considering how governments create ‘fungibility’ between the greenhouse abatement facilitated as a result of LGC creation and other sectors where the Australian Carbon Credit Unit (ACCU) represents one tonne of abatement.¹⁹

To create ‘fungibility’, it is first necessary to define an exchange rate between LGCs (which represent 1 MWh of renewable energy production) and an ACCU (which

¹⁶ See <https://www.governanceinstitute.com.au/resources/governance-directions/volume-73-number-5/risk-management-and-climate-change/>, Accessed online on 24 June 2021.

¹⁷ See http://www.cleanenergyregulator.gov.au/DocumentAssets/Pages/Corporate-Emissions-Reduction-Transparency-Report-consultation-paper.aspx?utm_source=Clean+Energy+Regulator++Update&utm_campaign=aafe9cea8e-PJ554_CERT_Consultation&utm_medium=email&utm_term=0_56e080d9b7-aafe9cea8e-53060509, Accessed online on 24 June 2021.

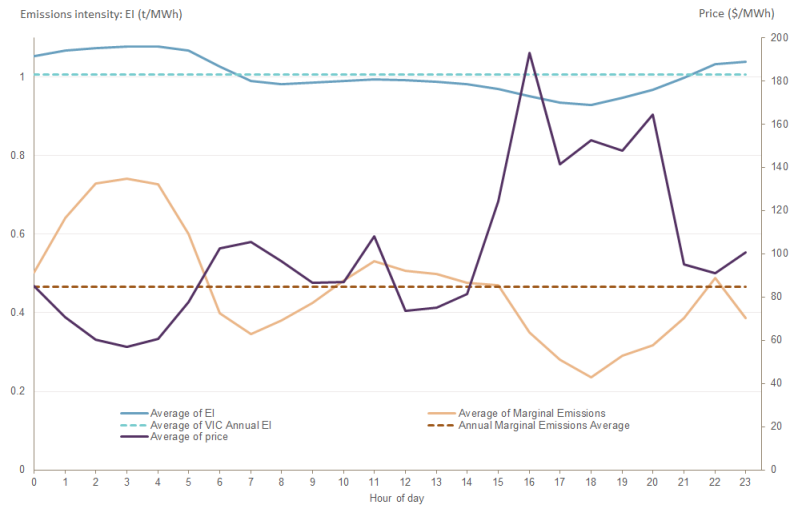
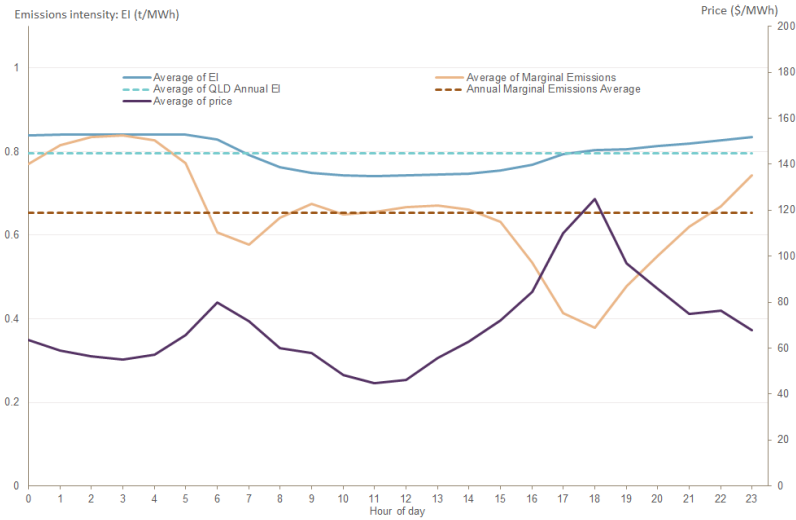
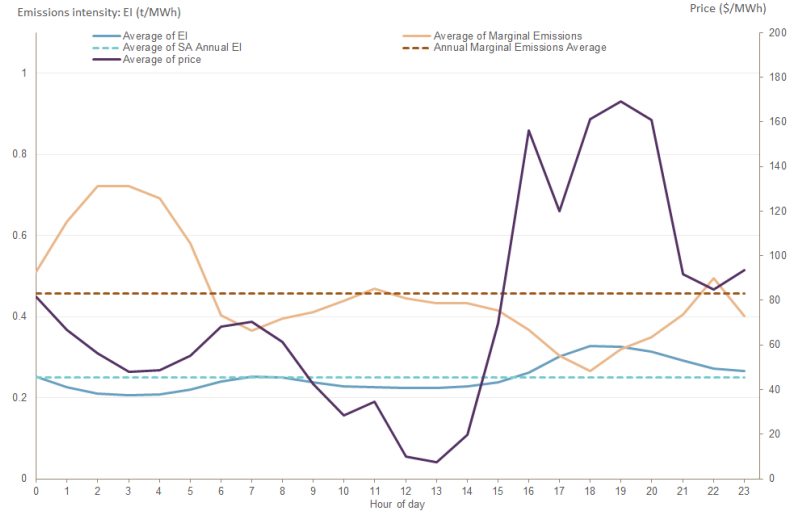
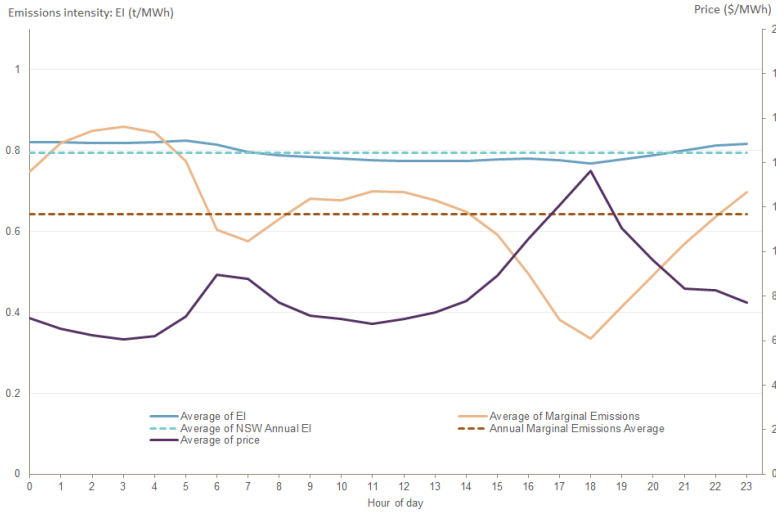
¹⁸ See <https://www.afr.com/policy/energy-and-climate/top-ceos-form-exclusive-climate-change-club-20201125-p56hvo> and <https://www.climateactive.org.au/buy-climate-active/certified-brands#7>, Accessed online on 20 June 2021.

¹⁹ An ACCU is a unit issued to a person by the Clean Energy Regulator (Regulator) by making an entry for the unit in an account kept by the person in the electronic Australian National Registry of Emissions Units (Registry). One ACCU represents one tonne of abatement. The predominant buyer of ACCUs is currently the Commonwealth Government through the Emissions Reduction Fund, although voluntary demand for ACCUs to offset emissions is growing.

represent 1 tonne of greenhouse abatement). This is achieved through converting LGCs into ACCUs through measuring the tonnes of abatement per MWh of renewable electricity generated and consumed. Nelson et al (2020) proposed that exchange rates could be based upon the *average emissions intensity (EI)* or the *marginal emissions intensity* at a point in time (such as each half hour of settlement within the NEM) or over a year.

To consider the most appropriate exchange rate, we have calculated the average emissions intensity by half hour period, the average marginal intensity of emissions by half hour period, the average and marginal intensities across the entire year, and the wholesale electricity price by half hour. We utilised 2019 data and calculated these metrics for New South Wales, Queensland, Victoria and South Australia. We have not considered transmission flows. For example, NSW does not 'import' brown coal emissions from Victoria. Our calculations for marginal emissions are based on the emissions intensity of the marginal price setter(s) from AEMO's NEMDE dispatch engine. In other words, the emissions intensity of the unit(s) that would have supplied additional MW in that region but could be located anywhere in the NEM.

Figure 6: Average and marginal emissions intensity and correlation with wholesale electricity price (2019 data)



The results of our emissions intensity analysis are presented in Figure 6. The first clear trend is that emissions intensity (particularly marginal emissions intensity) and price are anticorrelated. During periods of low prices, coal units are typically setting the price. If renewable generators produce at times of higher market prices, they are offsetting a generator that, on average, is almost half as emissions intensive (i.e. a blend of gas and hydro). Given the diurnal nature of electricity markets, marginal emissions are low during the evening peak and higher overnight.

Another key observation is that marginal emissions are similar in all regions (as the NEM is often unconstrained, with similar price setters across all regions) but average emissions vary significantly by state (due to the different composition of generation). In particular, the average is lower in South Australia which has the highest penetration of large- and small-scale variable renewable generation. Importantly, average emissions do not change significantly throughout the day, but follow similar trends.

We recommend that policy makers set LGC/ACCU exchange rate fundamentals using the *average annual emissions intensity* of the entire NEM. The only way marginal emissions intensities could be used in a meaningful way would be through dynamic marginal emissions pricing (i.e. LGC conversion rates that vary every half hour). In practice, this would be incredibly difficult and administratively burdensome. Alternatively, average emissions intensity provides an accurate outcome when considered across the entire market (recall Figure 3). As the NEM will increasingly be interconnected through transmission built out under the Integrated System Plan (ISP), it is increasingly certain that generation in any state will reduce emissions across the NEM.

Another dynamic that policy makers will need to consider in relation to the future of the RET is the development of a ‘green hydrogen’ industry within Australia. All governments in Australia are becoming increasingly aware of the strategic risks associated with being so heavily reliant upon export revenues from commodities with a declining role in a carbon constrained future. Assuming that global demand for coal and natural gas will fall in the coming decades, economists and policy makers are turning their attention to strategic opportunities for new products and services which Australia may have a comparative advantage in. Both Commonwealth and state governments have indicated that hydrogen will be a key focus given it has significant potential to replace export earnings from coal and gas as an energy export. Furthermore, Australia has some of the best solar and wind resources in the world, an abundance of land and existing energy export infrastructure that could be utilised to support hydrogen (or ammonia) exports.²⁰

A key feature of ‘green hydrogen’ will be a requirement for some form of ‘guarantee of origin’ to provide buyers with confidence that the hydrogen has been produced using renewable energy. In the same way that the RET today is the policy architecture that underpins voluntary purchases of renewable energy, it is recommended that policy makers adopt the LGC as the ‘currency’ for creation of green hydrogen. To achieve this, the only policy amendment necessary would be facilitation of the LGC registry continuing to exist

²⁰ About 99% of hydrogen produced today is sourced from natural gas or coal/ lignite, with less than 1% coming from electrolysis. Of the three major production methods – (1) steam methane reforming (SMR), (2) coal gasification and (3) electrolysis – only ‘green’ hydrogen from renewable sources achieves government objectives of decarbonisation. Currently, hydrogen from electrolysis is estimated to cost around A\$6.50-7.50/kg, but this is expected to fall to A\$2.00-3.50/kg by 2030 and A\$1.20-2.40/kg by 2050. To achieve cost parity with Australian natural gas, hydrogen would need to fall to ~A\$2/kg.

beyond 2030 (with powers provided to the CER to 'derate' LGCs created after 2030 by the compliance obligation which would no longer exist).²¹

By utilising LGCs when issuing Cfds or 'swaptions', creating fungibility between LGCs and ACCUs and utilising LGCs as a means of guaranteeing the origin of 'green hydrogen', Australian policy makers would have effectively facilitated a nationally consistent and integrated energy and climate policy (without purposely seeking to do so). Market participants would continue to be able to invest with confidence in new supply and governments would be less exposed to growing out-of-market obligations to finance poor projects. International investors would be able to purchase quality Australian carbon units with significant stimulus to the Australian economy.

5. Concluding Remarks

Freebairn (2020) provides a useful overview of how to consider a package of greenhouse abatement policies. While he argues a national emissions price is the most efficient policy tool, it is unlikely to be the only policy required. Two constraints exist to force this outcome. Firstly, institutional barriers, transaction costs and other non-price barriers will exist that mute pricing signals. Energy efficiency standards for new appliances are a good example of this first barrier. The second constraint relates to the real political economy and public resistance to emissions trading and 'carbon taxes'. In the Australian context the second constraint is likely to be more pervasive.

Climate policy will therefore need to evolve in a way that maximises economic efficiency but is able to be enduring given political realities. In the Australian context, it is worth considering recent community polling which indicates that 55 per cent of all voters agree with reducing emissions to 'net zero' by 2050 with 33 per cent undecided. At the same time, the proportion of voters that believe the target should be met through increased deployment of renewable energy is 61 per cent.²² As such, there is considerable merit in exploring how the RET architecture could be utilised to support growth in investment in renewables beyond the mandated 33 TWh by 2030.²³

This article has reviewed the effectiveness of the RET as a policy tool for driving investment in renewable energy and reducing emissions and contrasted it with emerging state-based Cfd style policies. The RET has been the primary policy tool for reducing emissions within Australia. In relation to its impact on electricity markets and consumers, we make two key findings:

Finding 1: The RET facilitated both positive and negative years of cashflow (relative to underlying LCOE). In other words, consumers benefited from overinvestment through lower prices (relative to LCOE) and all project proponents

²¹ This could be achieved by derating LGC production by the result of dividing the total LGC production minus 33 TWh (which is the compliance obligation which expires in 2030) by the total LGC production in any year.

²² Polling available at: <https://www.smh.com.au/politics/federal/voters-want-australia-to-set-a-net-zero-2050-emissions-target-but-no-carbon-tax-20210615-p5813w.html>, Accessed online on 19 June 2021.

²³ While economists would contend that a technologically neutral policy would be more efficient, almost all energy economists, market participants and the peak body in Australia have publicly stated that renewables are now the cheapest form of energy. See <https://thehub.agl.com.au/-/media/thehub/legacyimported/2018/05/presentation-for-grattan-2018.pdf?la=en&hash=773503322C309EBA6E8722F4734EA8CE> as a good example. Accessed online on 20 June 2021. Even though renewables are lowest cost, additional policies (such as Cfds using the RET policy architecture) and voluntary purchases of abatement are required to hasten the substitution of existing coal plants with firmed renewables in a manner consistent with meeting Australia's carbon budget implicitly committed to as part of the Paris agreement.

were required to address the risks associated with the NEM's spatial and temporal dynamics.

Finding 2: Without LGC revenue, all renewable projects would have experienced negative income (relative to LCOE) almost all the time. This has non-trivial implications for policy design. Cfd style policies would have resulted in much lower wholesale electricity prices to compensate for lost Cfd revenue. But governments or consumers could have been exposed to significant 'out of the money' Cfd liabilities. In other words, all producers would have been guaranteed to make a return on their investment: privatising profits and socialising losses.

Given state governments are pivoting towards Cfd auctions to facilitate new renewable investment, our policy recommendations relate to integrating the benefits of the RET and LGC framework within these auction processes. By writing the Cfd or swaption on the LGC, rather than the wholesale electricity price, policy makers could overcome the worst aspects of Cfds. Most importantly, new projects would continue to be exposed to dynamic spatial and temporal pricing signals and project proponents (rather than governments or consumers) would wear the risk of underperformance of their investment.

A further benefit of utilising the existing LGC framework is the integration of electricity sector abatement within a broader trend of corporates voluntarily reducing emissions.²⁴ This article has analysed half hourly marginal, average and annualised marginal and average emissions intensities and concluded that LGCs should be 'fungible' with ACCUs using the NEM annual emission intensity as an 'exchange rate'.

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²⁴ LGC prices have continued to be non-negative despite the RET being fully subscribed from a compliance perspective. This is due to continued growth in demand from electricity customers for LGCs to 'offset' their electricity consumption. Attachment 1 shows how forward LGC prices continue to trend above the fundamentals implied through a pure compliance lens.

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Appendix 1: LGC Price Curves

