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What does the Finkel Review mean for investors?

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The final report of the Independent Review into the Future Security of the National Electricity Market, commonly referred to as the 'Finkel Review' has been published. This paper outlines what it means for investors.

What is the Finkel Review?

The Finkel Review, chaired by Dr Alan Finkel, Australia's Chief Scientist, presents recommendations for the government with four key outcomes in mind, namely increased security, future reliability, consumer rewards and lower emissions.

In a bit more detail, the recommendations include increased security for stronger risk management to protect against natural disasters and cyber security attacks and future reliability for incentives for new generators to enter the market and it avoids existing low-cost generators exiting prematurely. The recommendations also reward consumers by achieving system upgrades and new generation at low cost while lowering emissions.

With regard to lower emissions, Australia has, as a signatory to the Paris Agreement, committed to 26-28% reductions in CO2 emissions by 2030 (from 2005 levels).

The preliminary report was released in December 2016 and following consultation, the final report was published on 9 June 2017. It also provides further recommendations for other regulatory bodies to follow up on.

What did the Finkel Review propose?

The key recommendation in the review was the introduction of a Clean Energy Target (CET) to replace the Renewable Energy Target (RET) by 2020. A CET focuses on emissions reductions rather than the promotion of renewable energy generation. The CET would subsidise power generation with relatively low carbon emissions intensity, while it would not penalise power generation with relatively high carbon emissions intensity (in contrast to an Emissions Intensity Scheme, or an 'EIS').

As it does not explicitly penalise carbon intensive emitters, the CET takes a 'technology neutral' approach and does not favour any particular technology over another. For example, new low emissions generators (e.g., wind and gas), as well as coal with carbon capture storage, could both receive incentives to enter the market. It will all depend on the threshold for carbon intensity.

What does it mean for climate change regulation?

Governments need to agree on a number of details and initially, the recommendations will be reviewed by the government and the opposition. Importantly, the final report did not recommend any exact threshold for carbon intensity or how many certificates should be issued; rather, it says the emissions reduction trajectory should be set, at a minimum, consistent with the national target to meet the Paris Agreement target.

A number of planned closures of coal-fired power plants will lower the emissions, which means reducing the electricity sector's emissions by 28% (in line with the Paris Agreement) is a relatively low target. However, it would not be sufficient to cut Australia's total emissions by 28% as the electricity industry accounts for approximately one third of Australia's CO2 emissions. As a result, we expect the government would either target further CO2 emissions in the Australian electricity market (i.e. above 28%) and/or target emissions reductions in other sectors, such as the transport sector, which accounts for approximately 15% of Australia's emissions.

In addition to the CET, Australia has a number of other alternatives for climate-change regulation, such as a cap-and-trade emissions scheme (ETS), carbon taxes, emissions purchasing schemes, forced shut-downs of coal-fired power plants and others. An ETS would bring revenue to the government and could deliver a target, but it would be complex and historically there have been several political barriers. A carbon tax would be less complex than an ETS, but would be even more difficult politically. An emissions purchasing scheme would not impact consumer prices, nor would it raise revenue, which is challenging from a budget perspective. Forced shut-downs of coal-fired power plants are unlikely to be delivered at low cost. In addition, there are also state-based schemes designed to incentivise renewable energy.

In short, there are pros and cons with most options for climate change regulation. While the key recommendations from the Finkel Review should be relatively easier to sell politically compared to other options at hand, there is still political risk as the review leaves a number of potentially sensitive details to be dealt with. Most notably, the carbon intensity threshold, i.e., what constitutes 'clean', could prove contentious, particularly around coal-fired power stations with carbon capture storage. The opposition has indicated that it would not support that approach, while elements of the current Government have a different opinion.

What does the framework mean for investors?

The recommendations, if adopted by Government, could provide more certainty, although the devil is in the detail. Crucially, it depends on the design of the CET; a carefully designed framework could provide the basis for an orderly transition away from high-emissions intensive power generation in Australia, but the design needs to reflect and balance market and technology pricing.

The CET is clearly supportive of gas-fired generators. Also, ultimately we believe thermal generators that remain operational will eventually pass on their higher costs to industry customers and consumers. This could have a minor negative impact on discretionary spending.

Depending on the final design, coal is unlikely be phased out as quickly as it would be under an EIS, which penalises high-emissions intensive generation. Modelling for the review estimates that by 2030, approximately 42% of electricity demand will be met by renewable energy generation.

While the Finkel Review did not explicitly set a carbon intensity benchmark, if we assume 0.7t CO2e/MWh (megawatt hour), there are a number of impacts for utilities sector participants. Origin Energy's electricity generators are primarily gas-fired. These assets are likely to be beneficiaries of the CET given the ability to partially generate a clean energy certificate for every MW generated.

In contrast, AGL Energy's generation portfolio is largely coal-fired. It will therefore not be entitled to the same level of certificates as competitor Origin, however, we inevitably expect the rising cost of electricity generation to be passed on to both household and industrial customers.

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