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South Australian Department for Energy and Mining

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South Australian Department for Energy and Mining – Firm Energy Reliability Mechanism – Stage 2 Consultation Paper

AGL Energy (**AGL**) welcomes the opportunity to make this submission in response to the South Australian Department for Energy and Mining's (**DEM**) Stage 2 consultation paper (**consultation paper**) on the Firm Energy Reliability Mechanism (**FERM**).

Key points

- AGL agrees the South Australia's energy system needs reliable long duration capacity that can operate in-region when required.
  - Priority should be given to ensuring the FERM aligns with the directions and recommendations of the NEM Wholesale Market Settings review.
- It is critical that the design of the FERM attracts the new market entry and new investment needed to secure reliable long duration capacity. The Stage 2 proposal is unlikely to achieve this.
  - As an alternative, we suggest adopting a framework that mirrors the New South Wales Long-Term Energy Service Agreement framework, ensuring participants are only paid at times when market conditions warrant it.
- The proposed FERM scheme imposes significant compliance risk on all participants, irrespective of whether they are receiving financial support and without clear justification that the increased regulatory burden will drive the desired market outcomes.
  - This may lead to perverse unintended consequences, including precipitating the early exit of existing long duration capacity.
- The proposed Market Liquidity Obligation and Reliability Obligation are unlikely improve reliability, but will increase costs and risks to participants, which will ultimately flow through to consumers.
  - Priority should be given to implementing a mechanism that complements market signals to appropriately value and incentivise long duration capacity, rather than imposing new obligations to address risks arising from the FERM support mechanism.

About AGL

At AGL, we believe energy makes life better and are passionate about powering the way Australians live, move and work. Proudly Australian for more than 185 years, AGL supplies around 4.5 million energy, telecommunications and Netflix customer services.[1] AGL operates Australia's largest private electricity generation portfolio within the National Electricity Market, comprising coal and gas-fired generation, renewable energy sources such as wind, hydro and solar, batteries and other firming technology, and storage assets. We are building on our history as one of Australia's leading private investors in renewable energy to now lead the business of transition to a lower emission, affordable and smart energy future in line with the goals of our Climate Transition Action Plan. We'll continue to innovate in energy and other essential services to enhance the way Australians live, and to help preserve the world around us for future generations.

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[1] Services to customers number is at 31 December 2024.

South Australia urgently needs long duration firm capacity in the electricity system

AGL agrees with the 'case for action' set out in the Stage 2 consultation paper – South Australia's energy system urgently needs reliable long duration capacity (**LDC**). Given the current lack of sufficient investment signals, AGL supports measures that provide financial support to incentivise LDC Providers to enter the South Australian market, while at the same time making deliberate efforts to minimise the cost impact on consumers.

South Australian households and businesses expect and deserve a reliable and resilient power system. The paper highlights several factors that will challenge system reliability and resilience over the next ten years. How these challenges will ultimately play out is not known. What is clear is that action needs to be taken and that the involvement of governments will be influential.

AGL looks forward to the FERM successfully driving the timely and effective delivery of secure, reliable, and affordable electricity supply. Significant change to the proposed design is essential to achieve this aim.

The FERM's effectiveness could be hindered by the introduction of new risks and burdens

AGL considers that policy mechanisms based on positive incentives drive more sustainable and innovative market responses than those based on penalties or strict compliance obligations.

While the FERM includes a mechanism to provide financial support to new LDC Providers, it introduces a significant number of unnecessary risks and burdens for market participants to manage which in almost all cases will not be receiving a direct benefit.

A range of tier one civil penalty provisions – which could attract penalties of up to $10 million – are proposed to be introduced covering a range of behaviours including:

- responding to an NOI request on time, and in accordance with requirements
- providing capacity if an entity has previously indicated an intention to provide capacity
- acting in accordance with a market liquidity obligation or reliability obligation

Also, while the focus of the FERM has been on long duration capacity providers , the FERM would impose several civil penalty obligations on a diverse range of market participants, including retailers, large load customers, new and existing LDC Providers (regardless of whether they are receiving financial support under the scheme), integrated resource providers and transmission network service providers.

AGL supports the success of the FERM scheme. To help achieve this, we consider the scheme needs to be amended so that it strikes the right balance between positive, market-based incentives and strict compliance obligations or penalties.

It is critical that the design of the FERM attracts the new market entry and the new investment needed to secure reliable long duration capacity.

The use of LOR events to measure performance may create adverse unintended consequences

It is proposed that the FERM will rely on Lack of Reserve (**LOR**) 2 or 3 events in South Australia to verify that long duration capacity providers contracted under the scheme are available and will physically provide their capacity commitment to the market when needed.

AGL considers this approach may create adverse unintended consequences.

It would be challenging for long duration storage to maintain a state of charge for potential LOR response while pursuing revenue opportunities, effectively forcing material reduction in revenue potential. Traditional gas generators can simply maintain fuel reserves, while batteries must actively forgo arbitrage opportunities. Perversely, retaining charge to be available for a future potential LOR event may precipitate an actual LOR event as they are incentivised to charge during stressed conditions, worsening system reliability. More broadly, AGL considers that using LOR events could distort the market. Submissions in response to the Stage 1 consultation paper raised this as an issue. Also, the removal of similar provisions from the federal Capacity Investment Scheme demonstrates that these market impacts are recognised.

The interaction between LOR penalties and cap and collar payments to new LDC Providers

LOR penalties and cap-and-collar revenue mechanisms may present significant challenges. Even a limited number of LOR events, if not managed effectively, can substantially diminish annual support payments which could undermine the intended revenue certainty and introduce considerable financial risk. This alone may disincentivise a potential new LDC Provider from participating in the FERM Tender.

Also, we should consider the potential experience of existing LDC Providers. They will not have the ability to benefit from the cap-and-collar revenue mechanism, however, will face the risk of LOR penalties. There is a real risk that the scheme could push existing LDC Providers out of the market sooner than they would have otherwise chosen to exit.

New South Wales' Long Term Energy Service Agreement framework may be a superior alternative to the LOR approach

The New South Wales Long-Term Energy Service Agreement (**LTESA**) framework offers a robust alternative to traditional reliability mechanisms by emphasising financial rather than physical performance metrics. Unlike approaches reliant on system reserve levels and LOR events, the LTESA uses dispatch weighted average prices and net operational revenues to assess performance. Structured as an option contract, it grants projects the right, but not the obligation, to access revenue support. This ensures that financial assistance is only exercised when market conditions warrant it. The design aligns incentives with genuine market participation, encouraging projects to engage actively across energy, ancillary services, and contract markets.

By decoupling revenue support from physical reserve triggers, the LTESA eliminates strategic withholding and gaming behaviours, fostering a more transparent and efficient market. Projects are rewarded for maximising operational performance and market engagement, rather than positioning for scarcity events. This approach not only enhances reliability outcomes but also protects consumers by ensuring support is only provided when wholesale prices are low. The LTESA framework represents a forward-thinking model that balances investment certainty with market discipline, making it a compelling mechanism for driving clean energy development in New South Wales.

Force majeure exclusions should be reviewed

The proposed exclusions for network events, fuel shortage, and normal wear and tear appear particularly problematic given South Australia's operational history. Network events have caused most historical separations, yet under the proposed FERM, assets would bear performance risk for circumstances entirely beyond their control. The "normal wear and tear" exclusion ignores that responding to frequent LOR events accelerates equipment degradation, creating a feedback loop of increasing maintenance requirements and penalty exposure.

Complexities with the cap and collar commercial model

A potential new LDC Provider would have to determine the cap and collar bid variables (i.e. the revenue floor, the revenue threshold, and the revenue ceiling) to include in their submissions to the FERM Tender. To do this, it seems each potential new LDC Provider would need to form a view, in relation to their proposed project, on the value of each of the 14 items across assessable revenue, excluded revenue, assessable costs and excluded costs that comprise the 'net revenue calculation'.

After the Minister's Guidelines are published in August 2025, potential new LDC Providers will have less than 8 weeks to familiarise themselves with the new Guidelines and Regulations and register and submit their tender submission. While we acknowledge the urgency, this timeframe may present some challenges.

While the SA FERM's cap and collar commercial model provides a level of revenue certainty, its reliance on annual revenue outcomes limits its responsiveness to short term market dynamics. In particular, the absence of mechanisms to align financial support with periods of low spot prices may result in support being provided when it is not required, or conversely, withheld when it is most needed.

This introduces a degree of uncertainty that may be problematic for both energy consumers (who ultimately fund the support) and potential investors, who rely on timely and transparent investment signals. Without greater alignment between support and market conditions, there is a risk that the model may either fail to attract the necessary investment or lead to overcompensation through conservative bidding strategies.

A more targeted and responsive approach could help ensure that financial support is both efficient and effective in meeting the scheme's objectives, while also providing greater assurance to consumers that costs are being minimised.

AGL considers the LTESA framework adopted in New South Wales offers a more flexible and investment-friendly approach. It is designed to reduce investor exposure to periods of low wholesale electricity prices while preserving the opportunity to benefit from stronger market returns. The LTESA achieves this by providing project proponents with a series of financial options, each linked to a defined operating period and exercisable over the duration of the contract. These options grant access to pre-agreed cash flows which are determined through a competitive tender process. This structure enables projects to manage revenue risk with greater precision and ensures that financial support is allocated in a targeted and transparent way.

The Market Liquidity Obligation and the Reliability Obligation

The proposed Market Liquidity Obligation (**MLO**) and Reliability Obligation (**RO**) are intended to enhance market transparency and reliability in South Australia and mitigate potential distortions from providing financial support to incentivise LDC Providers to enter the South Australian market. AGL considers the proposed MLO and RO are unnecessary, and that the proposed design would increase the costs for consumers without delivering corresponding benefits. They are proposed to address acknowledged flaws in the FERM cap and collar support model that are better addressed through design of the support model.

The Retailer Reliability Obligation (**RRO**) is already established within the broader NEM framework and is designed to support reliability by requiring retailers and large energy users to contract for their share of expected demand during periods of forecast shortfall. The RRO includes mechanisms that are functionally similar to the proposed MLO and RO.

A key distinction, however, is that the RRO must be triggered in response to identified reliability concerns, whereas the proposed MLO and RO would apply as standing obligations regardless of market conditions. This raises an important question about the rationale for imposing permanent obligations when a supply shortfall is not anticipated. The introduction of associated tier one civil penalty provisions, which may attract penalties of up to $10 million, introduces a South Australia-specific regulatory risk. This could influence investment decisions, with proponents potentially favouring jurisdictions in the NEM that do not carry similar obligations or penalties.

Further, given that the South Australian Minister already has the authority to trigger the RRO, the Government has existing tools to respond to reliability risks. Introducing a separate, parallel framework risks creating unnecessary complexity and cost for industry, without delivering clear additional benefits to consumers or the market.

The proposal does not recognise that existing commercial incentives already drive prudent risk management among both retailers and generators. This is evident in the active participation in contract markets, where hedging against peak demand and price volatility is standard practice. Imposing additional obligations risks duplicating these incentives without delivering clear benefits.

Finally, the operation of the proposed MLO and RO overlooks the natural hedging efficiencies within vertically integrated energy businesses. These entities inherently balance retail and generation exposures, reducing the need for external contracting. Mandating additional contracting or liquidity requirements would increase costs, which would ultimately be passed on to consumers. This would also undermine the operational and economic efficiencies that integrated businesses contribute to the electricity system.

Interaction with Nelson Review and other related reforms

We appreciate the South Australian Government is keen to proceed with implementing the scheme ahead of the Nelson Review's conclusion, in order to have the scheme operating by 2028. While our preference is that South Australia align with the outcomes of the broader NEM review, we understand the urgency driving the timeframes noted in this consultation. On this basis, we urge South Australia to consider that state-based reforms must balance participants' need for certainty, whilst leaving the door open for alignment with anticipated NEM-wide reforms.

We would be happy to discuss our submission in more detail with the DEM if this would be useful. Please contact [redacted]

Yours sincerely,

[redacted]

General Manager
Policy & Wholesale Markets Regulation