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Mr Simon Duggan

Deputy Secretary

Department of Climate Change, Energy, the Environment and Water

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### **Capacity Investment Scheme - Consultation**

AGL Energy (AGL) welcomes the opportunity to provide feedback on the proposed implementation of the Capacity Investment Scheme (CIS). Proudly Australian for more than 186 years, AGL supplies around 4.3 million energy and telecommunications customer services. AGL is committed to providing our customers simple, fair, and accessible essential services as they decarbonise and electrify the way they live, work, and move.

AGL operates Australia's largest private electricity generation portfolio within the National Electricity Market (NEM), comprising coal and gas-fired generation, renewable energy sources such as wind, hydro and solar, batteries and other firming technology, and gas production 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 emissions, affordable and smart energy future in line with the goals of our Climate Transition Action Plan (CTAP). This plan outlines AGL's own target of adding 5GW of new renewable generation and firming by 2030 and 12 GW by 2035 to supply our customer demand.

### **General Comments**

AGL supports the continued work by the Department to facilitate the substantial investment required to transition and decarbonise Australia's energy sector. This reform is fundamental to the Australian economy and the delivery of the Australian Government's 82% renewable electricity by 2030 target. This work will also support meeting commitments that have been made at a state and international level. AGL has deep experience and understanding of the opportunities and challenges of the transition across all aspects of the electricity supply chain, from our legacy bulk thermal generation through to the development of renewable, storage and hybrid technologies throughout the grid and, importantly, providing the retail services that end use customers need.

While the CIS is primarily focused on the needs of investors in new capacity, it is equally important that the policy design has a clear focus on ensuring that consumers benefit and can access competitive supply contracts, primarily through electricity retailers but also for the large customers who directly manage their own wholesale contracting. AGL has made several submissions to both the NSW Roadmap Long-Term Energy Service Agreements (LTESA) design process and previous CIS design consultation processes.<sup>1,2</sup> These have highlighted options to improve the schemes by strengthening contracting incentives to drive efficient outcomes while minimising adverse unintended consequences.

The proposed design of the CIS is intended to reduce financial risks to investors in the energy transition. While this addresses a key risk faced by investors in new projects, we consider there remain other risks and

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<sup>1</sup> See AGL submission to Capacity Investment Scheme Public Consultation Paper, available [here](#).

<sup>2</sup> See AGL submission to Draft LTESA Term Sheets, available [here](#).



barriers to the deployment of 32 GW of renewable capacity and clean dispatchable capacity projects by 2030, which the design of the scheme does not necessarily address.

Some of these challenges arise from the need for coordination of all market reforms under development. Landmark reforms include potential changes to transmission access, a process now having been underway for several years and that continues to pose significant risks of curtailment to developers. Additionally, we have previously provided feedback on the proposed Orderly Exit Management Framework (OEMF), particularly the risk of distortions arising from requiring significant amounts of generation that were forecast to exit to remain in the market while concurrently seeking to drive more supply into that same market. The potential price suppressing effect of the OEMF in such circumstances could have significant implications for the costs of the CIS and for existing assets, such as renewable plant, that are not underwritten by an LTESA or CIS contract. This is particularly the case post-2030 after the Renewable Energy Target rolls off. It will be important for taxpayers and energy consumers to coordinate investment and disinvestment interventions under the CIS and OEMF.

There are also several non-market risks that sit outside the scope of the CIS design, which need to be addressed concurrently with the CIS. These include planning approvals, connection processes, and supply chain constraints including workforce availability affecting the construction of new projects and social license issues, as identified in the Draft 2024 Integrated System Plan for the NEM.<sup>3</sup> While the Government's Rewiring the Nation plan will have positive impact on some of these issues, particularly in expanding transmission capacity, significant barriers to project development remain.

Given the size of investment that the CIS is seeking to support, limited information has been provided on some material elements of the architecture of the CIS. While we understand this may be because they are still being considered by policy makers, it prevents investors and consumers from advising on potential approaches, and therefore risks reducing the potential effectiveness of the CIS in delivering its stated outcomes. Two key aspects that are fundamental to the operation of the CIS are the Tender Guidelines that will provide an appropriate level of detail on the eligibility criteria and merit assessment, and the Renewable Energy Transition Agreements (RETAs) that underpin not only the locational aspects of where projects are to be deployed but also further specificity around aspects of eligibility and project merits.

AGL is committed to actively engage in the ongoing development of the CIS scheme. We note that the detailed design of the CIS will be critical to its effectiveness, and there are substantial risks that taxpayers and energy consumers may face significantly higher costs than necessary if projects are poorly selected or incentivised.

To counter this risk, projects that are developed under this scheme must be appropriately diverse (both in terms of location and technology), and the appropriate signals must remain in the market to support the efficient operation of contract markets, which are critical to supporting the long-term interests of energy customers. We support the approach to modelling the financial value of projects across a range of future market scenarios, which is intended to give greatest value to projects with the right capacity in the right location. It will be important that this modelling also considers coincidence and diversity of production from variable renewables, and technical and locational factors for projects (such as constraints and loss factors). We encourage the Government to consult on the development of the scenarios and assessment approach with market participants who have experience in the complexities of making these types of assessments.

We welcome the recognition in the design paper of the need to manage risks to contract market liquidity. The scale and nature of the CIS poses significant risks to contract markets, which in turn poses significant risks to

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<sup>3</sup> AEMO, [Draft 2024 Integrated System Plan](#), section 8.3



consumers. The role of electricity contract markets may seem abstract, however the price and availability of hedging contracts available to retailers to cover customer load directly impacts the prices customers pay.

A successful transition must deliver all aspects of the energy trilemma – affordability, reliability and low emissions. If contract market competitiveness and liquidity is not maintained, there is a risk that the benefits of new investment in renewable and storage will not translate fully to benefits on customers' bills. The proposed design parameters go some way to addressing this risk, including removing the risk of double liability, however the risk remains particularly in periods of high prices when customers most need contract cover that the CIS revenue ceiling may bind. Proposed requirements on storage to hold 50% of their capacity in reserve combined with requirement for projects to be within special purpose vehicles and not contract as part of a portfolio will also limit their ability to prudently sell forward contracts.

We have provided answers to the specific questions posed in the consultation paper in the appendix to this letter.

We thank the department for the opportunity to make this submission and we would be pleased to discuss any of the points raised in this submission. If you have any follow up question please contact Chris Streets, Senior Manager Policy and Regulation on +61 4109 533 584 or at [cstreets@agl.com.au](mailto:cstreets@agl.com.au)

Yours sincerely,

Ralph Griffiths

General Manager Policy and Markets Regulation



## **Appendix 1 – Responses to questions raised in the consultation paper**

### **1. Cadence of tender schedule and products**

AGL supports the proposal to run simultaneous Generation and Clean Dispatchable CISA tenders on a 6-monthly basis. However, as the consultation paper indicates, this is very likely to result in circumstances where the results from previous tender rounds are not known before the next round begins. The tender process should be designed to minimise the negative implications of this. The assessment process should be completed as expeditiously as possible, and the process for participants to participate in multiple auction processes for the same project should be streamlined. To the extent possible, and within probity constraints, participants in each auction process should be provided with relevant feedback to enable subsequent bids or to update bids for a subsequent tender process.

Submitting a tender requires a significant amount of preparation, modelling and analysis. Where possible, providing as much notice as possible on upcoming schedules will assist and is best achieved through releasing a detailed tender schedule well in advance. At a minimum, the schedule should detail the likely timing of when a tender will be released, the type of tender (generation/dispatchable), the size of the tender (MW) and whether it's location specific. With the quantum of potential projects that are under varying stages of development across the NEM, this level of detail will enable market participants to prepare high quality proposals enabling the scheme to deliver better outcomes.

### **2. Incentives for participation in contract markets**

AGL welcomes the recognition of the importance of maintaining contract market liquidity, preserving electricity market signals, and preserving incentives for proponents to participate in contract markets.

The fundamental design of the support arrangement as a revenue floor and ceiling does inherently reduce incentives for contracting. This is because the main objective of the scheme, to provide protection against wholesale price risk, will reduce market incentives for participants to seek to enter into long-term contracts to perform the same function.

The revenue ceiling may also impact on incentives for participants to offer products into the contract market. This is because the revenue ceiling potentially creates a revenue gap that may reduce incentives for forward contracting in higher price periods. Unfortunately, this is precisely when it will be most essential for retailers and market exposed customers to be able to access effective wholesale contracts to manage their market exposure. It is likely that high price periods would align with circumstances of tight supply/demand balance which may trigger the retailer reliability obligation (RRO), in which case market customers and retailers may be unable to meet the RRO's minimum contract cover obligations. While much will depend on the level at which the floor and ceiling prices are struck, alternative support approaches could be considered. These could, for example, be structured around recovering profits at a higher threshold, rather than a simple percentage of all revenues above the ceiling. This may better maintain incentives and the ability for CISA supported projects to participate in contract markets. We encourage the government to continue to consult on these issues, especially given that the impacts may become more prominent as the CIS begins to deliver more capacity into the market.

It is not clear from the consultation paper how derivatives will be accounted for in the assessment of revenues. The ultimate value of a futures contract is uncertain until after the period covered by the contract has passed, which may be several years from when any initial premium is received. The recognition of the ultimate costs and revenues arising from futures contracts may not be captured within the quarterly assessment or annual reconciliation. We encourage the Government to consult further on the accounting methodologies.



The design paper recognises that the requirement for projects to be structured as SPVs may limit the type of contracts that can be sold, and that the proposed LOR3 performance requirement is distortionary and overrides market signals. However, it is also important to recognise the cumulative impact of these requirements in reducing the potential volume of forward contracts available to customers and reducing incentives for clean dispatchable projects to put downward pressure on wholesale spot prices. The requirement to retain 50% of generation for LOR3 events would significantly reduce the capacity of the project to defend contracts it has sold. The impact would be exacerbated by the SPV requirement as two projects operating on a standalone basis are exposed to greater risk in selling a given contract volume than the same two projects acting as a portfolio. Together with the reduced incentive to sell forward contracts above the revenue ceiling, the cumulative impact may severely impact the availability, liquidity and price of forward contracts. Contract prices and availability directly impact retail electricity prices. Low levels of contract cover would also reduce incentives for dispatchable generators to defend spot market prices, leading to higher and more volatile spot prices.

We support removal of the risk of 'double liability' by including the net impact of Eligible Wholesale Contracts in the revenue calculation for projects.

Preserving contracting incentives is particularly critical for dispatchable generation CISAs. We note the Government's intention for the next CIS round to focus on renewable generation and encourage the Government to consult further on contracting options for clean dispatchable well ahead of the next round of clean dispatchable CISA tenders.

### **3. Merit and eligibility criteria**

We note that the Tender Guidelines are yet to be developed. As the Department recognises, it will be critical that the eligibility criteria are clearly defined and that the merit assessment is well understood.

Greater clarity on the eligibility criteria is necessary to focus time and resources used for preparing a tender submission. One example of this is the eligibility requirements for projects to demonstrate secure access to land and whether this means the project must have secured its access to make a submission or whether the submission only needs to demonstrate how it will secure access to land. It is particularly important for such elements to be clearly defined where the RETAs may allow for varying eligibility requirements on a state-by-state basis.

One additional area that we consider needs further clarification is in relation to the merit assessment around different technologies. The consultation paper does not explain whether the CIS will target specific technologies based on market needs. For the CIS to deliver its policy objective of filling expected generation and reliability gaps, it must stimulate investment towards quality projects that support the right balance of generation needs. For example, the merit criteria and assessment process, should be set up to rank those projects that contribute to increasing system reliability and address market gaps over those generation technologies that flood generation in the market and lead to curtailment. Further, this assessment should also look at the potential shape of energy generation and its correlation with energy demand. We would also raise the significant market benefits that a hybrid project, with firming renewables, potentially brings to the market. This further highlights the necessity of having a clearly defined merit assessment that allows market participants to appropriately value the benefits of such hybrid projects as opposed to structuring separate projects that apply for CIS tender rounds separately.

We acknowledge that virtual power plants, demand response, and other virtual aggregation and flexible load technologies will not be eligible for upcoming CIS tenders. Given their importance to the achievement of current renewable energy targets, we welcome the intention to include these technologies in future tenders and would be keen to engage further with the department on how best to integrate them into the CIS.



#### **4. *Special Purpose Vehicle (SPV) requirement***

AGL understands the rationale behind the inclusion of this requirement and is supportive of the potential for alternative options under different CISA arrangements. A challenge arising is that using an SPV as envisaged would potentially reduce some of the portfolio benefits that would otherwise exist, which could result in requirements to bid in at a higher price floor.

#### **5. *Eligible Wholesale Contracts***

We are concerned that the proposed criteria would present a significant barrier to effective participation in that market for both AGL and our counterparties.

AGL has concerns with the inflexible nature of the proposed eligibility criteria for wholesale contracts. Additional factors that could negatively impact signals to provide contract market liquidity should be minimised or wholly removed, in line with the principle of minimising the schemes impact on the current market operation.

We consider that the requirement for a one-year contract duration is inconsistent with current market contracting practices and is not required for the operation of the scheme. Products are often traded under substantially shorter periods on both the ASX and via OTC trades. To do so is to impose further barriers to participation in secondary markets with the resultant effect of reducing electricity retailers ability to purchase derivative products as part of their hedging strategy.

Similarly, we also consider the negative pricing provisions may be problematic in their proposed format. We support exploring alternative options to cap government exposure to liability under a CISA.

#### **6. *Alternative options for Generation CISAs to preserve incentives to participate in wholesale contracts***

AGL is strongly supportive of further development of alternative commercial options that would be allowable under the CIS. The array of projects needed for an effective transition and a secure and reliable grid may not be adequately incentivised under a one-size-fits-all model of CIS contracting. The currently proposed model is strongly geared towards stand-alone projects, backed by financial institutions rather than existing market participants. By focusing on minimising downside risk, the scheme would effectively insulate a significant proportion of future generation from the required market signals to enter contracts. This diminishes their usual counterparties' ability to manage their own risk exposure and could negatively impact competition in the retail market were smaller retailers to choose to exit. Options that allow for the additional benefits of generation to be contracted with retail customers or support risk management on behalf of customers are strongly encouraged. Given the substantial targets for new generation by many of the major existing market participants it is imperative that those investments are not jeopardised as they are highly likely to be strongly correlated with managing customer demand. We would be open to further engagement with the department on what commercial options may work better for market participants that have substantial risk management obligations on behalf of their customers.

#### **7. *LOR3 capacity requirement for clean dispatchable generation***

There may be challenges with the proposed a performance pay requirement for clean dispatchable generation which requires that a project must bid at least 50 per cent of its contracted capacity during an actual Lack of Reserve (LoR) 3 event. This is a significant impost for projects and is likely to drive up floor prices. This requirement also inhibits the total capacity available to the market during normal operation (resulting in higher wholesale prices) and may even contribute to conditions giving rise to a LOR3 event. We understand the intent of this requirement to contribute to system security. In this instance, system security may be better served by setting a lower capacity requirement for LOR3 events which enables a greater



proportion of clean dispatchable capacity to participate in the market on an ongoing basis, thereby reducing the likelihood of LOR3 events.

We encourage the Government to review the necessity for this requirement which the paper acknowledges is distortionary and which as we note above is likely to significantly reduce participants ability to sell contracts. The electricity energy and FCAS markets are specifically designed to provide signals and incentives to optimise the use of storage assets for the market and consumers. Importantly AEMO has all the powers necessary under rules to direct all scheduled generators and storage providers to maintain system security and reliability. Instead of the blunt requirement to retain 50% of capacity for LOR3 events the CISA could retain some obligations to maximise plant availability in periods of forecast low reserve margins.