office of the tasmanian economic REGULATOR

Wholesale Contract Regulatory Instrument Pricing Investigation

Consultation Paper

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INVITATION TO MAKE SUBMISSIONS

It is the Economic Regulator's policy to publish all submissions on the Office of the Tasmanian Economic Regulator's (OTTER) website unless the author of the submission requests confidentiality in relation to the submission (or any part of the submission). Those parts of a submission that are requested to be confidential should be submitted as an attachment to that part suitable for publication.

The Economic Regulator will not publish submissions which contain material that the Economic Regulator believes is, or could be, derogatory or defamatory.

Submissions should be received by close of business on 23 November 2017.

To facilitate the publication of submission on OTTER's website, submissions by email are preferred. Submissions and enquires may be made to:

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A copy of this Consultation Paper is also available on the Economic Regulator's website: www.economicregulator.tas.gov.au.

Following consideration of submissions, the Economic Regulator will publish a final investigation report on its website.

1 BACKGROUND

The Economic Regulator is responsible for the regulation of Hydro Tasmania's wholesale contract activities and for the administration of the Wholesale Contract Regulatory Instrument (the Instrument) under the *Electricity Supply Industry Act 1995* (ESI Act).

Under section 43G of the ESI Act the Instrument contains a number of 'approvals', made by the Minister or the Economic Regulator. These approvals relate to the types of contracts that Hydro Tasmania must offer as regulated contract products, the standard form(s) of these contracts and the methodology for determining the prices and volumes of contracts that must be offered.

Regulation 21 of the *Electricity Supply Industry (Pricing and Related Matters) Regulations 2013* (the Pricing Regulations) requires the Economic Regulator to conduct a pricing investigation prior to revoking or making an approval. The Regulator completed a pricing investigation into the Wholesale Contract Regulatory Instrument (Instrument) in March 2017 with the new Instrument commencing on 24 March 2017.

Recently an issue has been identified with the operation of the Instrument. Depending on market conditions in Victoria, there is potential for the Instrument to calculate negative prices for regulated peak cap contracts. Current market conditions in Victoria make this potential outcome quite likely. Such an outcome is considered inconsistent with the underlying intent of the Instrument to deliver regulated contract prices that are broadly reflective of competitive market outcomes.

Market situation

As discussed later, regulated peak cap prices in Tasmania under the Instrument are determined with reference to Victorian market peak cap prices, amongst other things.

Victorian peak cap prices have historically been relatively stable. However, recently there have been significant increases in Victorian peak cap prices for Q1 2018. This is likely to be due to concerns about capacity to meet demand in the Victorian market over the summer period, following the closure of Hazelwood and other broader concerns around renewables and gas. However, after Q1 2018 Victorian peak cap prices return to "normal levels" for the remaining three quarters, but peak again in Q1 2019. While Victorian peak cap prices are usually higher in Q1, due to that period typically covering peak demand in the Victorian market, the price difference is currently markedly more pronounced.

This trend in Victorian peak cap prices has resulted in the Instrument producing Tasmanian peak cap prices that have been falling as the Victorian peak cap prices have risen.

Reasons for regulated peak cap price outcomes

Under the Instrument, the calculation of the baseload cap value for Tasmania involves modifying Victorian peak cap prices over the next four quarters, and subtracting the resulting value from the estimated discounted cost of a new gas peaking plant entering the Tasmanian market.

The estimated discounted cost of the new gas peaking plant is a set value calculated according to the Regulator's inputs set out in Schedule 1(6) of the Instrument.

The identified issue has arisen due to the method of modifying the Victorian peak cap prices. The modification involves summing the differences between the Victorian peak cap prices for each of the next four quarters and the lowest of those four prices. For example, if the Victorian peak cap prices for the next four quarters were $10, $8, $6, and $8, the modified value would be $8 ($4+$2+$0+$2). Consequently, the bigger the difference between the highest and the lowest Victorian peak cap prices over the next four quarters, and the more high prices there are compared to the lowest price, the larger the modified value.

Subtracting these resultant large values from the estimated discounted cost of the new gas peaking plant (which is a relatively constant value) is leading to very low (and potentially negative) Tasmanian peak cap prices.

Proposed action

To avoid the potential for the Instrument to generate negative peak cap prices in the future, the Economic Regulator proposes the implementation of a floor price for regulated peak cap prices calculated under the Instrument, such that regulated peak cap prices will not be permitted to be lower than the floor price. Schedule 1 of the Instrument has an assumed off-peak cap price in Tasmania of $1.14/MWh. From a conceptual point of view, it makes sense that regulated peak cap prices should not be lower than the assumed off-peak cap prices. Therefore, the Economic Regulator proposes setting the regulated peak cap floor price as being equal to the assumed off-peak cap price.

Modelling undertaken by the Office of the Tasmanian Economic Regulator has shown that this proposal will not significantly affect the prices of other contracts regulated under the Instrument. It will, however, prevent negative prices for regulated cap contracts.

Under the legislation, the Economic Regulator does not have the ability to amend the existing Instrument to prevent the outcome of negative peak cap prices. The Economic Regulator can only revoke the existing Instrument and issue a new Instrument. Additionally, the legislation does not allow the Economic Regulator to revoke the existing Instrument and make a new one unless it first conducts a pricing investigation. The Economic Regulator has, therefore, decided to conduct another pricing investigation to revoke the current Instrument and make a new Instrument. The Economic Regulator considers that this course of action has the benefit of ensuring the integrity of the wholesale contracting regulatory framework as well as providing certainty for market participants and maintaining a consultative and transparent approach to wholesale contract regulation.

Objective of investigation

The objective of the pricing investigation is to provide information to the Regulator to determine whether to revoke the existing Instrument and remake the Instrument to implement a floor price for regulated peak cap contracts.

2 CLAUSE 11.1 OF THE WHOLESALE CONTRACT REGULATORY INSTRUMENT

Clause 11.1 of the Instrument currently calculates the Baseload Cap Value as follows:

11.1 Tasmanian Baseload Cap Value

The Baseload Cap Value for a Quarter is calculated as follows:

$BCV = FSF \times ABRCV_{FLEX} + PCV - ABRCV_{FLEX}$

Where:

(a) BCV is the Baseload Cap Value for the Quarter, in $/MWh;

(b) FSF is the Flex Scale Factor for the Quarter, calculated in accordance with clause 11.2;

(c) $ABRCV_{FLEX}$ is the Flexible Portion of the Annual Baseload Reference Cap Value for the Quarter, in $/MWh, calculated in accordance with clause 11.5;

(d) PCV is the Peaker Capacity Value for the Quarter; in $/MWh, calculated in accordance with clause 11.6; and

To introduce a floor price for regulated cap prices equivalent to the assumed off-peak cap price, it is necessary to amend the above formula so that it continues to function as it does now, but that the calculated regulated cap price is equal to the maximum of the current price calculation and the assumed off-peak cap value.

Therefore, it is proposed to remake the Instrument with Clause 11.1 altered to read as follows (with changes relative to the current formula shown in red).

11.1 Tasmanian Baseload Cap Value

The Baseload Cap Value for a Quarter is calculated as follows:

$BCV = MAX(FSF \times ABRCV_{FLEX} + PCV - ABRCV_{FLEX}, OCV)$

Where:

(a) BCV is the Baseload Cap Value for the Quarter, in $/MWh;

(b) FSF is the Flex Scale Factor for the Quarter, calculated in accordance with clause 11.2;

(c) $ABRCV_{FLEX}$ is the Flexible Portion of the Annual Baseload Reference Cap Value for the Quarter, in $/MWh, calculated in accordance with clause 11.5;

(d) PCV is the Peaker Capacity Value for the Quarter; in $/MWh, calculated in accordance with clause 11.6; and

(e) OCV is the Off-Peak Cap Value for the Quarter, in $/MWh, calculated in accordance with clause 12.3.

Matters to be addressed in submissions

The Regulator invites comments on the proposal to revoke the current Instrument and to remake the Instrument altering clause 11.1 as proposed above.

3 NEXT STEPS

Following consideration of submissions made in response to this Consultation Paper, it is intended that the Economic Regulator's final investigation report will be published on 1 December 2017 along with the associated approvals that will be made under section 43G of the ESI Act.