



**Wholesale Contract Regulatory Instrument Pricing  
Investigation**

**Final Report**

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# 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 method 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 Instrument in March 2017, with the new Instrument commencing on 24 March 2017.

Recently an issue was 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 baseload cap contracts in Tasmania. This risk has been realised with negative prices being generated for regulated baseload cap contracts over recent weeks. 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.

## 1.1 Market situation

Under the Instrument, regulated baseload cap prices in Tasmania are determined with reference to Victorian market cap prices, amongst other things.

Victorian cap prices have historically been relatively stable. However, recently there have been significant increases in Victorian 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 generation. After Q1 2018 Victorian peak cap prices return to "normal levels" for the remaining three quarters, but peak again in Q1 2019. While Victorian cap prices are usually higher in Q1 due to that period typically covering peak demand (summer) in the Victorian market, the price difference is markedly more pronounced at present.

This trend in Victorian peak cap prices has resulted in the Instrument producing Tasmanian baseload cap prices that have fallen as Victorian cap prices have risen, and recently resulted in negative regulated baseload cap contract prices in Tasmania.

## 1.2 Reasons for regulated peak cap price outcomes

Under the Instrument, the calculation of the baseload cap value for Tasmania involves modifying Victorian 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 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 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 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) has led to very low Tasmanian regulated baseload cap prices and, more recently, negative prices.

## 1.3 Objective of pricing investigation

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

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

On 9 November 2017, the Economic Regulator announced its intention to conduct a pricing investigation to revoke the current Instrument and make a new Instrument. The Economic Regulator considered that this course of action has the benefit of ensuring the integrity of the wholesale contract regulatory framework, as well as providing certainty for market participants and maintaining a consultative and transparent approach to wholesale contract regulation.

The objective of the pricing investigation was 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 baseload cap contracts.

## 2 ISSUES AND DECISION

The Economic Regulator released a Consultation Paper on 9 November 2017 outlining the proposed changes to clause 11.1 of the Instrument, and invited interested parts to make a submission.

### 2.1 Clause 11.1 of the Wholesale Contract Regulatory Instrument

#### 2.1.1 Existing 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<sub>FLEX</sub> 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.*

#### 2.1.2 Proposed Changes to the Instrument

To introduce a floor price for regulated baseload cap prices equivalent to the assumed off-peak cap price, the Regulator proposed in its Consultation Paper to amend the above formula. The formula will continue to function as it does now, but with an added qualifier such that if the calculated regulated cap price falls below the assumed off-peak cap value, the assumed off-peak cap value will serve as the regulated cap price.

Therefore, the Regulator 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:

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

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<sub>FLEX</sub> 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.*

## 2.2 Submissions

The Regulator received submissions from Hydro Tasmania and Aurora Energy.

Both parties agreed that the current method for calculating regulated baseload cap prices was leading to outcomes that are inconsistent with the underlying intent of the Instrument.

Both parties were also supportive of the issuing of a revised Instrument with Clause 11.1 amended as outlined in section 2.1.2 of this report.

## 2.3 The Economic Regulator's Decision

The Economic Regulator has considered the submissions received and decided to revoke the current Instrument and issue a new Instrument to implement a floor price for regulated baseload cap prices calculated under the Instrument, as described in section 2.1.2 above.

The Regulator has also decided to update the Schedule 1 values in the new Instrument to reflect the revised values that were consulted upon earlier in the year and were determined by the Regulator to apply from 1 September 2017.