WHOLESALE ELECTRICITY COSTS FOR 2020

A REPORT FOR THE ESSENTIAL SERVICES COMMISSION

12 NOVEMBER 2019

CONTENTS

1	**Introduction**	**3**
1.1	Background	3
1.2	Frontier Economics’ engagement	3
1.3	This final report	3
1.4	Previous advice to the ESC	3
1.5	Changes since the draft report	4
2	**Approach to assessing WEC**	**5**
3	**Half-hourly spot prices and half-hourly load**	**7**
3.1	Historical data on half-hourly price and load	7
3.2	Selecting appropriate historical data	8
3.3	Projecting half-hourly load and spot prices	16
4	**Contract prices**	**24**
5	**Contract position**	**29**
6	**Wholesale electricity costs**	**41**
6.1	Wholesale electricity costs	41
6.2	Volatility allowance	49
7	**LRET and SRES**	**50**
7.1	LRET	50
7.2	SRES	51

Tables

Table 1: 12-month trade weighted average ASXEnergy derivative prices for Victoria 25

Table 2: Modelled market-based wholesale electricity cost result 43

Table 3: Modelled volatility allowance 49

Figures

Figure 1: Load factor for residential customers 10

Figure 2: Load factor for business customers 10

Figure 3: Average daily profile for residential customers 11

Figure 4: Average daily profile for business customers 11

Figure 5: Average daily profile for Victorian spot prices 12

Figure 6: Load premium for residential customers, based on Victorian spot prices 13

Figure 7: Load premium for business customers, based on Victorian spot prices 13

Figure 8: Quarterly patterns of spot prices and ASXEnergy prices 15

Figure 9: Peak/off-peak patterns of spot prices and ASXEnergy prices 15

Figure 10: Distribution of load-weighted price for simulate d years for residential and business load – CitiPower 19

Figure 11: Distribution of load-weighted price for simulated years for residential and business load – Powercor 20

Figure 12: Distribution of load-weighted price for simulated years for residential and business load – AusNet 21

Figure 13: Distribution of load-weighted price for simulated years for residential and business load – United 22

Figure 14: Distribution of load-weighted price for simulated years for residential and business load – Jemena 23

Figure 15: Victorian base swaps – open interest, prices and volumes for calendar year 2020 26

Figure 16: Victorian peak swaps – open interest, prices and volumes for calendar year 2020 27

Figure 17: Victorian base $300 caps – open interest, prices and volumes for calendar year 2020 28

Figure 18: Contract position for CitiPower residential load, ASXEnergy contract prices, calendar year 2020 (2020 dollars) 31

Figure 19: Contract position for Powercor residential load, ASXEnergy contract prices, calendar year 2020 (2020 dollars) 32

Figure 20: Contract position for Jemena residential load, ASXEnergy contract prices, calendar year 2020 (2020 dollars) 33

Figure 21: Contract position for AusNet residential load, ASXEnergy contract prices, calendar year 2020 (2020 dollars) 34

Figure 22: Contract position for United residential load, ASXEnergy contract prices, calendar year 2020 (2020 dollars) 35

Figure 23: Contract position for CitiPower business load, ASXEnergy contract prices, calendar year 2020 (2020 dollars) 36

Figure 24: Contract position for PowerCor business load, ASXEnergy contract prices, calendar year 2020 (2020 dollars) 37

Figure 25: Contract position for Jemena business load, ASXEnergy contract prices, calendar year 2020 (2020 dollars) 38

Figure 26: Contract position for AusNet business load, ASXEnergy contract prices, calendar year 2020 (2020 dollars) 39

Figure 27: Contract position for United business load, ASXEnergy contract prices, calendar year 2020 (2020 dollars) 40

Figure 28: Comparison of ranking methods on the WEC 42

Figure 29: CitiPower load wholesale electricity cost distribution 44

Figure 30: Powercor load wholesale electricity cost distribution 45

Figure 31: AusNet load wholesale electricity cost distribution 46

Figure 32: United load wholesale electricity cost distribution 47

Figure 33: Jemena load wholesale electricity cost distribution 48

1 INTRODUCTION

Frontier Economics has been engaged to advise the Essential Services Commission (ESC) on allowances for wholesale electricity costs for calendar year 2020 for retailing electricity to small customers, for the purposes of determining the Victorian Default Offer (VDO).

1.1 Background

The ESC is required to determine prices for the VDO to apply from 1 January 2020. To inform this the ESC needs forecasts of retailers' wholesale electricity costs and of retailers' costs of complying with environmental programs for calendar year 2020.

1.2 Frontier Economics' engagement

Frontier Economics has been engaged by the ESC to provide advice on two aspects of the VDO:

- The wholesale electricity cost (WEC) component of retailers' cost to supply small customers from 1 January 2020.
- The retailers' costs of complying with the Large-scale Renewable Energy Target (LRET) and the Small-scale Renewable Energy Scheme (SRES) in supplying small customers from 1 January 2020.

1.3 This final report

This final report sets out our advice to the ESC on the WEC and costs of complying with the LRET and the SRES, for retailers in each of the five Victorian distribution network areas. This report is structured as follows:

- Section 2 provides an overview of the approach used to estimate wholesale energy costs.
- Section 3 discusses the half-hourly prices and half-hourly load used in our analysis.
- Section 4 discusses the contract prices used in our analysis.
- Section 5 discusses the assumed contract position.
- Section 6 provides our estimate of the WEC.
- Section 7 provides our estimates of the costs of complying with the LRET and SRES.

In addition to this report, we also provide spreadsheets setting out details of half-hourly load and price forecasts, contract positions resulting from our modelling, and calculations for determining the WEC.

1.4 Previous advice to the ESC

Frontier Economics has previously advised the ESC on the WEC and the cost of complying with the LRET and the SRES for financial year 2019/20.[1] This final report adopts substantially the same approach

[1] Frontier Economics, *Wholesale Electricity Costs*, A report for the Essential Services Commission, 24 April 2019. Available on the ESC's website: https://www.esc.vic.gov.au/electricity-and-gas/inquiries-studies-and-reviews/electricity-and-gas-retail-markets-review-implementation-2018/electricity-and-gas-retail-markets-review-implementation-2018-victorian-default-offer#tabs-container2

for estimating WEC and the costs of complying with the LRET and the SRES for 2020 as we previously adopted for 2019/20.

1.5 Changes since the draft report

We have made a number of changes to our draft report as a result of the availability of new information:

- We have used more recent ASXEnergy contract prices.
- We have used more recent LRET certificate prices.

We have also made two minor changes to our approach, in response to submissions received on our draft report:

- When scaling half-hourly spot prices to match prices for ASXEnergy base swap contracts, as discussed in Section 3.3, we have ensured that the resulting half-hourly spot prices are not lower than the market price floor or higher than the market price cap. We inadvertently omitted this step in our work for the draft report. This has a very minor effect on the resulting WEC.
- When determining the WEC, as discussed in Section 6.1, we base the WEC on the WEC for the median simulated year when all simulated years are ranked according to WEC, rather than the WEC for the median simulated year when all simulated years are ranked according to load weighted price. This has a small effect on the resulting WEC.

In finalising our report the ESC has asked us to review in detail the submissions by ACIL Allen Consulting for the Australia Energy Council[2] and by Oakley Greenwood for GloBird.[3]

[2] ACIL Allen Consulting, *Wholesale Electricity Costs, Victorian Default Offer 2020*, Report to Australian Energy Council, 23 October 2019.

[3] Oakley Greenwood, *Review of wholesale component of Victorian Default Market Offer*, Prepared for GloBird, 23 October 2019.

2 APPROACH TO ASSESSING WEC

Under the settlement rules in the National Electricity Market (NEM) retailers are responsible for purchasing electricity to meet the load of their customers in the wholesale electricity market. A retailer will pay, for each half hour, its customer’s electricity load in that half-hour multiplied by the relevant regional reference price from the wholesale electricity spot market for that half hour. For customers in Victoria, the relevant regional reference price is the Victorian regional reference price.

These settlement payments that retailers face can be extremely volatile. Electricity load for small customers can vary significantly from one half hour to the next, and electricity spot prices can be anywhere between the Market Price Cap (which is currently $14,700/MWh) and the market floor price (which is -$1,000/MWh). Since retailers will typically commit to supply their customers at a specified retail price for a period of time, this volatility in settlement payments can result in retailers paying more for electricity than they receive for that electricity through the retail price they have agreed with their customers. At worst, this exposes the retailers to the risk of financial failure.

To manage the risks associated with volatile load and spot prices, retailers will typically seek to hedge their exposure to spot prices by entering into hedging arrangements. There are a number of ways that retailers can hedge their exposure to spot prices. The most common are the following:

- Vertical integration through ownership of an electricity generator. A retailer that owns a generator has what is known as a natural hedge: when the spot price is high, the retailer will have to pay the high spot price for its customer’s load but, as the owner of a generator, will also receive the high spot price for its electricity generation.
- Power purchase agreements with a generator. Power purchase agreements provide a similar hedging benefit to vertical integration, but they do so through contractual arrangements between a retailer and a generator, rather than through ownership.
- Financial derivatives. There are a range of financial derivatives that are available to retailers (and generators) to hedge their exposure to volatile spot prices. The most common are swap contracts (which effectively lock-in a spot price for the counterparties) and cap contracts (which effectively cap the spot price for a retailer). These are traded both on the stock exchange and over-the-counter between participants.

Retailer’s energy purchase costs are typically taken to be the average cost to a retailer of purchasing electricity from the wholesale market for its customers, taking into account both the retailer’s settlement payments to the Australian Energy Market Operator (AEMO) and the financial outcomes from the retailer’s hedging arrangements.

Regulatory practice in Australia has typically focused on estimating the energy purchase cost for a benchmark retailer. In doing so, regulators have typically assumed that the benchmark retailer will make use of exchange-traded financial derivatives to hedge its exposure to spot prices. The assumption that a benchmark retailer will use exchange-traded financial derivatives is typically based on the following reasoning:

- Any retailer of a reasonable size should be able to hedge its exposure to wholesale spot prices using exchange-traded financial derivatives, while vertical integration and entering power purchase agreements can be impractical for retailers with a smaller retail position in a market or with a less certain retail position.

- Prices for exchange-traded financial derivatives are transparent, since they are traded on the ASX. In contrast, the costs of building generation plant or entering into power purchase agreements is less transparent.

In practice, it is clear that retailers in the NEM do adopt a mix of hedging strategies, including vertical integration and power purchase agreements. Retailers will presumably vertically integrate or enter into power purchase agreements because they think these strategies offer advantages that financial derivatives cannot; by excluding vertical integration and power purchase agreements from consideration, therefore, regulators will, if anything, tend to overstate the costs that retailers will face, or understate the risk management that retailers can achieve.

We follow this typical approach of assessing the WEC that retailers face based on an estimate of the cost that a prudent retailer would face in supplying electricity to their customers, having regard to the hedging contracts that a prudent retailer is likely to enter into. The hedging contracts that we base this analysis on are quarterly base swaps, peak swaps and base caps, traded on ASXEnergy.

To estimate WEC in this way, we need to answer four questions:

- What is the expected half-hourly load of the retailer's customers?
- What are the expected half-hourly spot prices that retailers will face?
- What is the cost of financial hedging contracts?
- What kind of hedging position is a prudent retailer likely to adopt?

From the answers to these questions we can calculate the WEC that a retailer would face.

We address these questions in the sections that follow.

3 HALF-HOURLY SPOT PRICES AND HALF-HOURLY LOAD

This section addresses the first two questions we need to answer to estimate WEC:

- What is the expected half-hourly load of the retailer's customers?
- What are the expected half-hourly spot prices that retailers will face?

We deal with these questions together because we believe it is important to forecast half-hourly spot prices and half-hourly load in a way that accounts for the correlation between prices and load. After all, this correlation is a key driver of the risks that retailers face.

3.1 Historical data on half-hourly price and load

Our modelling of the WEC requires projections of half-hourly spot prices in Victoria and customer load to be supplied by retailers in Victoria.

In our view, the best source of data about half-hourly patterns of spot prices, half-hourly patterns of customer load, and the correlation between the two, is historical data. The historical data on prices and load will reflect all of the complex factors that drive both spot prices and customer load, and the interactions between them, which are difficult to accurately capture at the half-hourly level using forecasting models. These historical data on prices and load can then be scaled to account for any trends in prices and load over the forecast period.

The historical data that we use is:

- For prices, the half-hourly spot prices for the Victorian regional reference node, as published by AEMO.
- For customer load, half-hourly load data that AEMO has directly provided to the ESC on customers with annual consumption less than 40MWh for each of the five distribution network areas in Victoria. AEMO has provided separate half-hourly load data for residential customers with annual consumption less than 40MWh and for business customers with annual consumption less than 40MWh.

We use this data directly provided by AEMO because it closely coincides with the customer groups to which the VDO will apply:

- For residential customers, the VDO will apply to all residential customers. The data provided by AEMO is only for residential customers with annual consumption less than 40MWh, but since very few residential customers will have annual consumption greater than 40MWh this is unlikely to make a material difference to the estimated WEC.
- For small business customers, the VDO will apply to small business customers, with small business customers defined as customers with aggregate consumption less than 40 MWh per annum. The data provided by AEMO aligns with the applicability of the VDO.

In contrast, the Manually Read Interval Meter (MRIM) data that is publicly available from AEMO includes aggregated half-hour electricity consumption for all type 5 meters in each of the five distribution network areas in Victoria. This includes a mix of residential and business customers with annual consumption up to 160MWh.

3.2 Selecting appropriate historical data

When using historical data on prices and load in this way, a useful starting point is to choose data on prices and load from an historical period that we think is likely to be most consistent with the forecast period. For example, the closure of coal-fired power stations may have substantial impacts on price levels and volatility. Likewise, the increasing adoption of rooftop solar PV is likely to materially affect load factors and prices over time.

The data that is directly provided by AEMO is for 2016/17, 2017/18 and 2018/19. (When we undertook this analysis for the VDO for 2019/20 we did not yet have access to the full set of data for 2018/19). Ideally, we would have a longer time series of data. If the price and load data for this longer time series were deemed likely to be a reasonable indication of outcomes for the forecast period, then the longer series of data would likely include a broader range of potential market outcomes that could be captured in our Monte Carlo analysis (discussed in Section 3.3). However, in our view, the benefit of having more recent data, and load data that better matches the customers to which the VDO will apply, clearly suggests the data directly provided by AEMO is preferable to the longer set of publicly available MRIM data.

Response to submission

In its report for GloBird, Oakley Greenwood raised concerns about the Monte Carlo approach only using the past three historical years of data. Oakley Greenwood argued that a better approach would be to use the three years of historical data to determine "the statistical correlation between underlying energy consumption and temperature over the three year sample frame". From there, Oakley Greenwood propose that a Monte Carlo sampling technique could be used for historical weather over a longer period of time, with the results of the statistical correlation used to developed load forecasts from the resulting weather patterns. It appears that Oakley Greenwood consider that the main advantage of this approach is that it allows "the simulated load profile that is developed to be genuinely probabilistic, because it samples from the entire temperature history rather than implicitly assuming that the last three years of weather, as well as the timing of when that weather occurs – e.g., weekends V weekdays – is reflective of the full range of outcome".[4]

Our view is that Oakley Greenwood's proposed approach could improve forecasting outcomes, but only if a robust 'statistical correlation' between load and temperature can be developed. And developing an econometric model to achieve this faces many difficulties. An obvious difficulty is that it is not just temperature that determines energy consumption over the three years for which we have data; there are a range of other factors that are likely to have affected energy consumption over this period, including: other weather conditions (humidity, wind speed, the extent to which high temperatures are prolonged); the number of customers; the appliance mix of customers (particularly the extent to which customers have air conditioning and solar PV panels); the energy efficiency of appliances; the housing stock (how many customers are in apartments and houses); the building standards for the stock of dwellings; and prices for electricity, including the tariff structure.

In order to accurately assess the statistical correlation between load and temperature it would be necessary also to account for factors such as these that have a material effect on load. Any econometric model that seeks to do this will be imperfect, and will potentially introduce errors into the forecasting

[4] Oakley Greenwood, *Review of wholesale component of Victorian Default Market Offer*, Prepared for GloBird, 23 October 2019.

process. Given that we would need to develop at least 10 models – one for each of residential and business customers in each network area – and that relevant data is unlikely to align with each network area, an approach like this will rely on imperfect data inputs. This will increase the potential for errors to be introduced into the forecasting process.

Even aside from the potential to introduce errors into the forecasting process, there are significant disadvantages to Oakley Greenwood's proposed approach.

First, there are many different data sources and model specifications which could be used to determine the statistical correlation between load and temperature, and it is very likely that judgement will be required in determining which data source and which model would be best suited to the task. As a result, an approach of this kind will, in our view, be much less transparent and predictable than the current approach.

Second, in order to ensure we capture the correlation between load and prices it would be necessary to also develop a methodology for determining the relationship between temperature and price. One approach would be to also develop an econometric model of prices, with temperate as an explanatory variable. This, however, would suffer from the same difficulties, although more acutely, as an econometric model of load. A second approach – proposed by Oakley Greenwood – would be to use a price simulation model. However, this would run directly counter to the preference of many stakeholders to maintain a transparent approach that makes use of public market data. A third approach – also proposed by Oakley Greenwood – would be to "overlay simulated demands on the most recent bid/offer data for the Victorian region". However, this would first require us to also forecast total system demand (in a manner consistent with the forecasting of each individual load profile) and would then require arbitrary decisions about which half-hourly bid/offer data to align with which half-hourly load forecast. We do not think this is a reasonable approach for forecasting prices.

In short, given the very significant difficulties in implementing this approach, the likelihood that, even with the best effort, forecasting errors would be introduced, the fact that this approach would substantially reduce transparency and predictability, and the observation that weather patterns over the last 3 years have not been that dissimilar to weather patterns over the longer-term, we do not think it is a preferable approach.

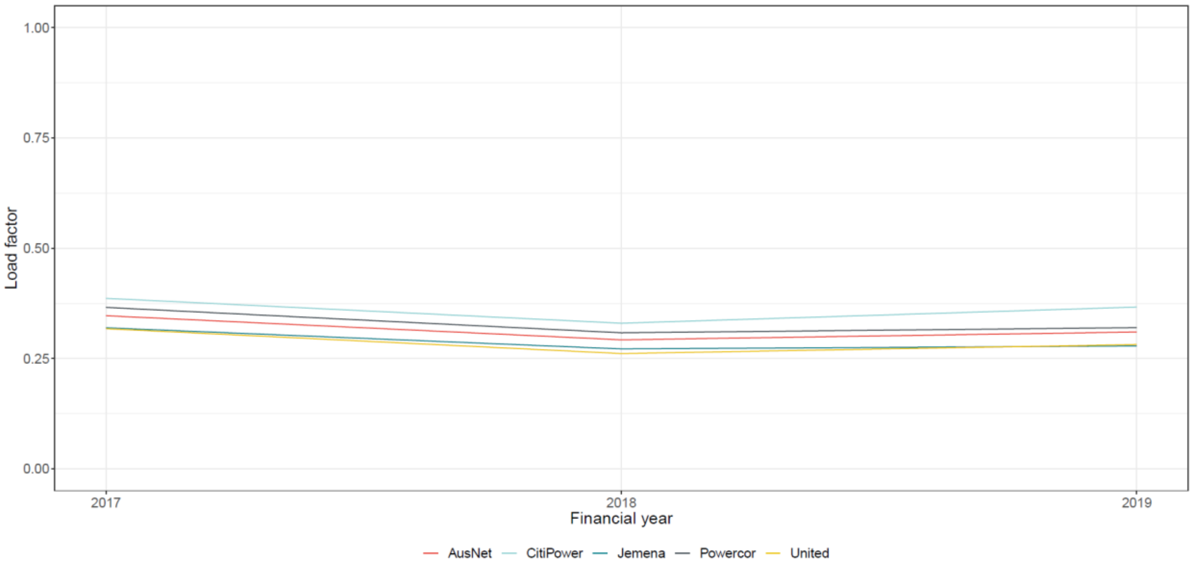
Analysis of data

Figure 1 shows the annual load factor for the residential data for each Victorian DNSP for the last two financial years. We can see that there is a slight drop in load factor for every DNSP from 2016/17 to 2017/18, before an increase again in 2018/19.

Figure 2 shows the annual load factor for business data for each Victorian DNSP for the last two financial years. We can see that there was a slight increase in the load factor from 2016/17 to 2017/18 for AusNet and Powercor, but that on the whole the load factors gave remained relatively steady.

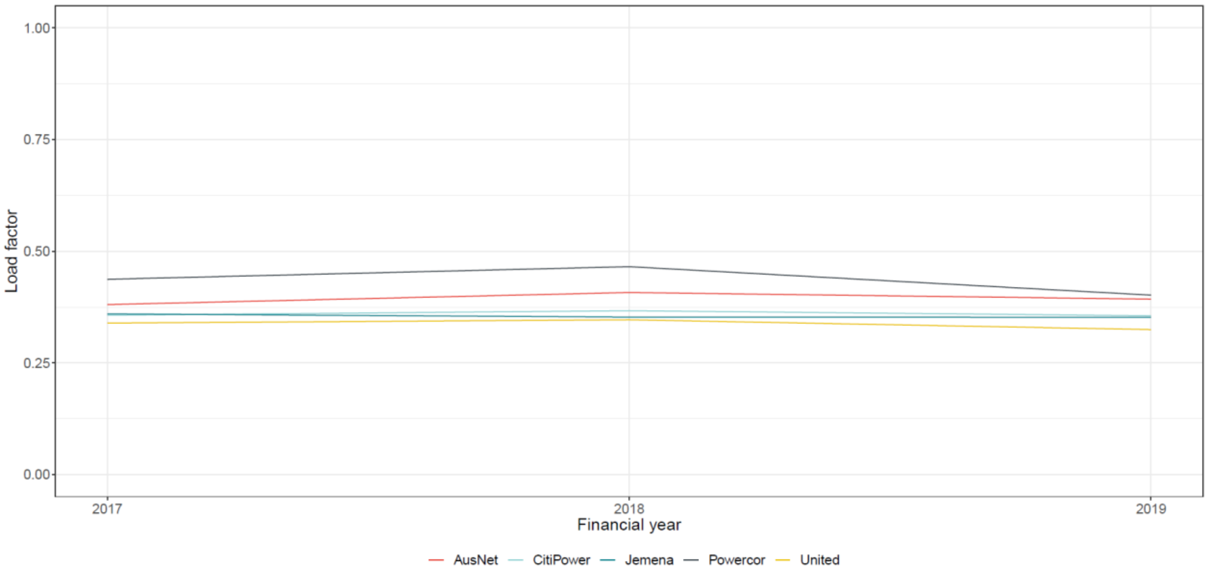
Figure 3 and **Figure 4** show the average daily profile for residential and business data respectively for each Victorian DNSP for the last three financial years, normalised to the same annual consumption to highlight differences in the timing of daily consumption. These profiles are almost identical between years, with only slight relative reductions in load during the day for residential and business customers in some network areas.

Figure 1: Load factor for residential customers



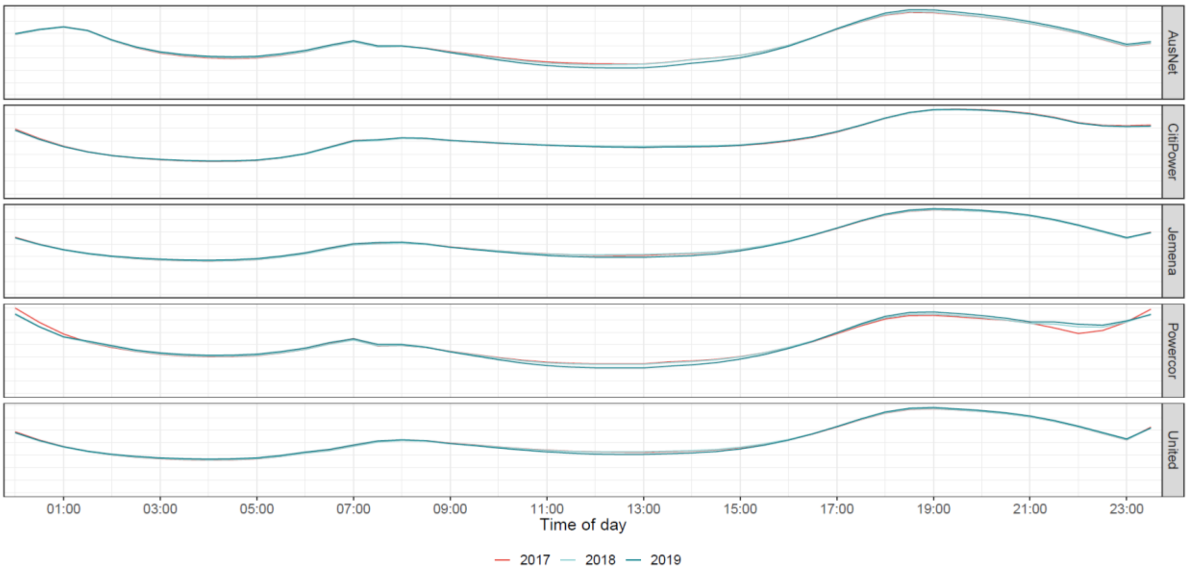
Source: Frontier Economics analysis of AEMO data

Figure 2: Load factor for business customers



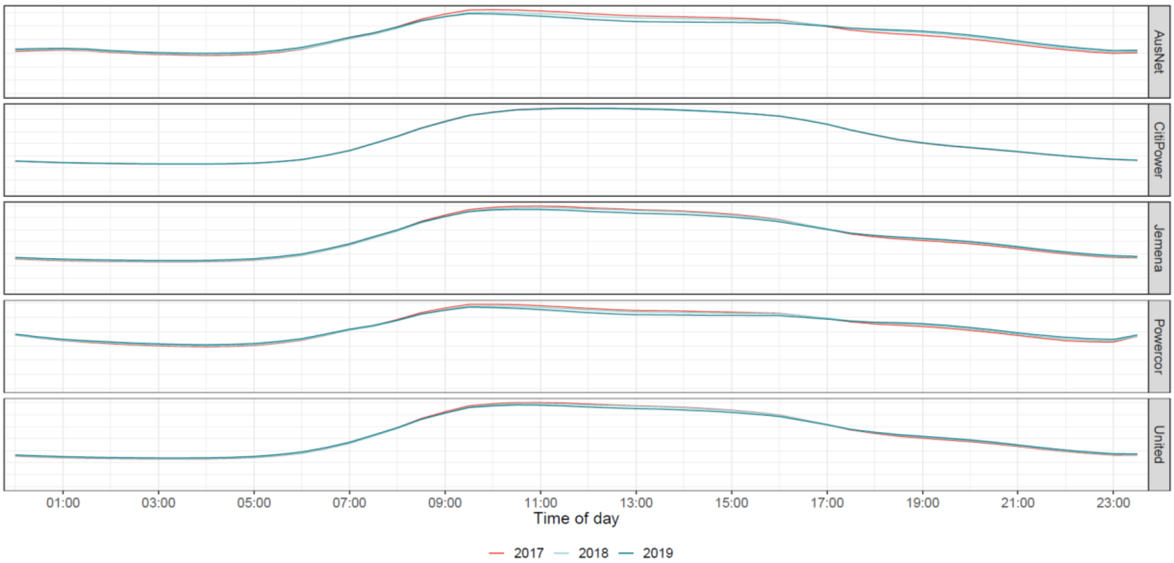
Source: Frontier Economics analysis of AEMO data

Figure 3: Average daily profile for residential customers



Source: Frontier Economics analysis of AEMO data

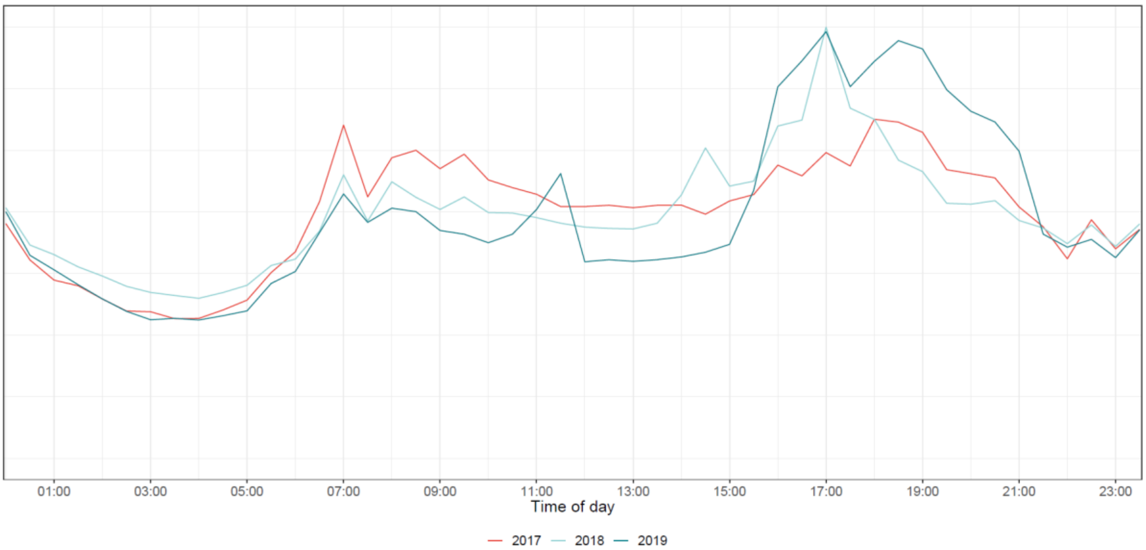
Figure 4: Average daily profile for business customers



Source: Frontier Economics analysis of AEMO data

Figure 5 shows the average daily profile for Victorian spot prices for the last three financial years. It is no surprise to see that there is greater volatility in daily patterns of spot prices than there is in daily patterns of customer load. However, in each case we do see similar patterns of low overnight prices, a price spike tending to occur in the morning, and further high prices tending to occur in the mid-afternoon to evening. The spot price data for 2018/19 shows that higher prices persisted for longer in the evening in 2018/19 than they did in 2016/17 or 2017/18.

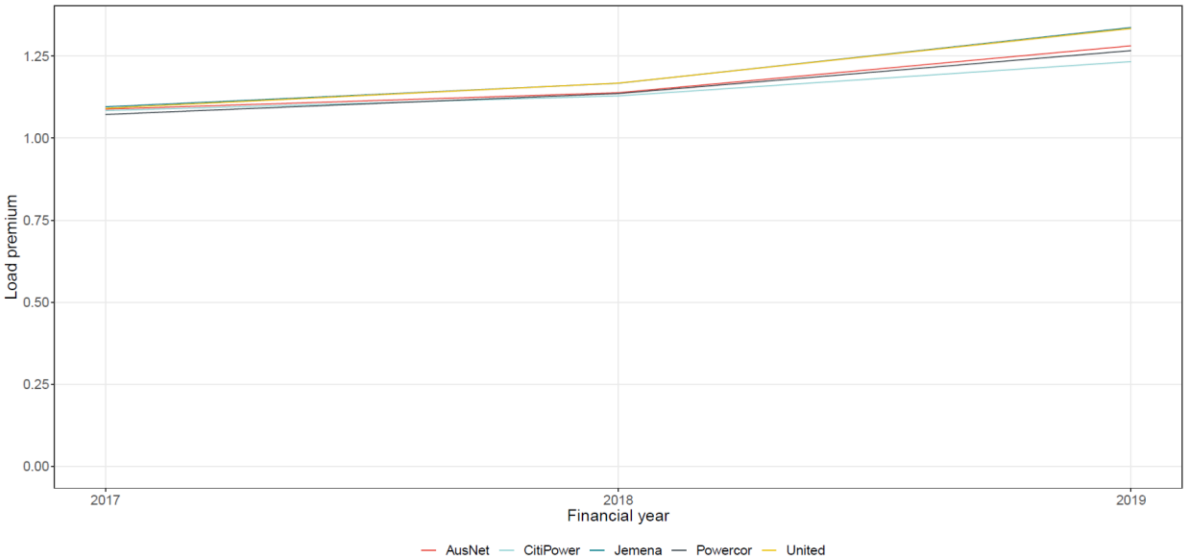
Figure 5: Average daily profile for Victorian spot prices



Source: Frontier Economics analysis of AEMO data

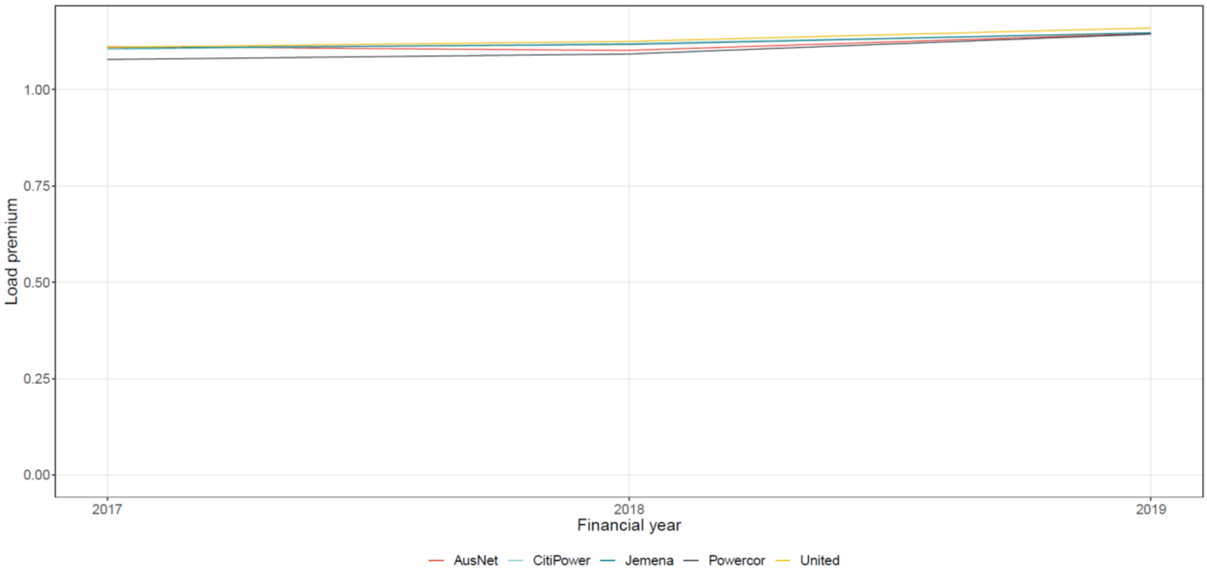
Figure 6 and **Figure 7** combine the historical customer load data and spot price data to report the load premium (calculated as the load-weighted price divided by the time-weighted price) for each customer type, for each Victorian DNSP and for each of the last three financial years. In our experience, the load-weighted spot price (and, by extension, the load premium) is a reasonable guide to the WEC. We can see from **Figure 6** and **Figure 7** that the load premium over 2016/17 and 2017/18 was reasonably constant, but increased more significantly in 2018/19.

Figure 6: Load premium for residential customers, based on Victorian spot prices



Source: Frontier Economics analysis of AEMO data

Figure 7: Load premium for business customers, based on Victorian spot prices



Source: Frontier Economics analysis of AEMO data

As well as examining historical data it can be useful to compare historical price outcomes with expectations of future prices, based on ASXEnergy contract prices. Since we will ultimately be scaling historical half-hourly prices to an average price based on ASXEnergy contract prices, it is helpful if the historical patterns in half-hourly prices are reasonably consistent with the pricing outcomes indicated by ASXEnergy contract prices.

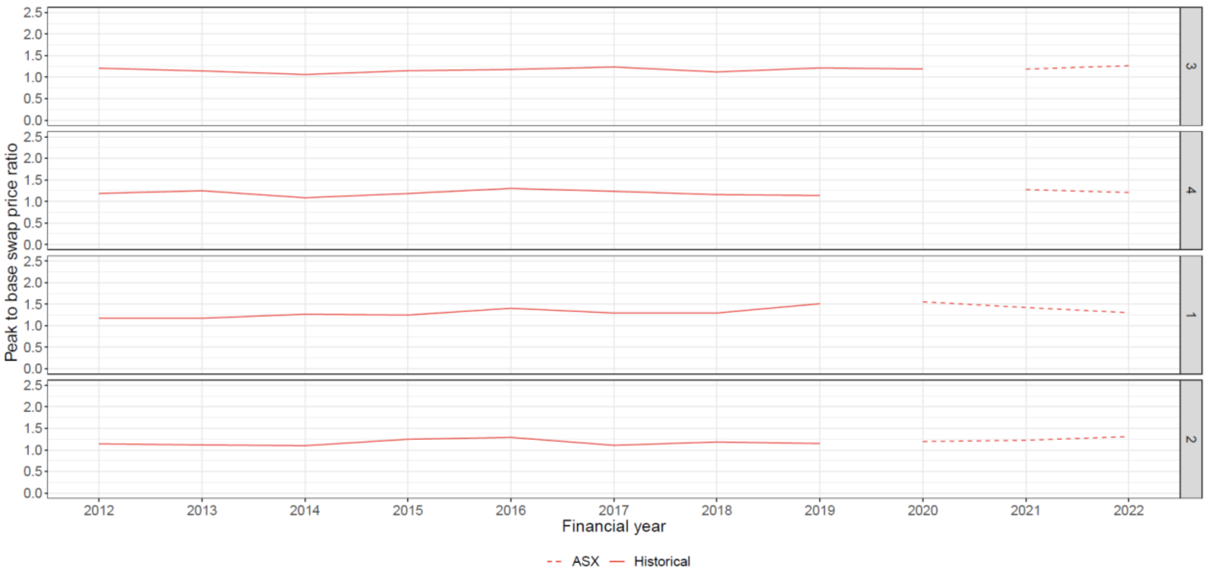
Figure 8 examines quarterly patterns of spot prices and ASXEnergy prices. For each quarter, **Figure 8** presents the relationship between average quarterly prices and average annual prices: on an historical basis this relationship is based on historical Victorian spot prices; on a forecast basis this relationship is based on ASXEnergy base-load swaps prices for Victoria. **Figure 8** reveals quite a degree of volatility in the relationship between quarterly prices over time: average prices have tended to be highest in Q2 or Q3, but in recent years we have seen the highest prices in Q1. This is consistent with ASXEnergy data, which sees the highest prices for Q1 contracts. In any case, to minimise any potential issues with scaling historical half-hourly prices to ASXEnergy prices with a different quarterly pattern, we scale historical half-hourly prices to ASXEnergy prices on a quarterly basis, so that the quarterly patterns of prices observed in the ASXEnergy data is also reflected in our forecast half-hourly prices. This is discussed in more detail in Section 3.3.

Figure 9 examines peak/off-peak patterns of spot prices and ASXEnergy prices. For each peak/off-peak period, **Figure 9** presents the relationship between average peak/off-peak prices and average annual prices: on an historical basis this relationship is based on historical Victorian spot prices; on a forecast basis this relationship is based on ASXEnergy base-load swaps prices for Victoria. **Figure 9** reveals that historically peak prices have tended to be higher than average and off-peak prices have tended to be lower than average (as would be expected) and that this pattern is also reflected in the ASXEnergy data.

Figure 8: Quarterly patterns of spot prices and ASXEnergy prices

Source: Frontier Economics analysis of AEMO data and ASXEnergy data

Figure 9: Peak/off-peak patterns of spot prices and ASXEnergy prices



Source: Frontier Economics analysis of AEMO data and ASXEnergy data

Based on the analysis of historical half-hourly load and half-hourly prices set out above, our approach for this report is to continue to adopt the approach that we adopted in our advice to the ESC for the VDO for 2019/20; that is, we continue to include all historical data available to us (in this case data from 2016/17, 2017/18 and 2018/19) in a Monte Carlo simulation when forecasting half-hourly load and half-hourly prices. Implicit in this approach is the assumption that patterns of load and prices for each of these three historical years can provide useful information on patterns of load and price outcomes for 2020.

As we have seen above, there has been little change in the average daily load profile for residential or small business customers, and, in our view, reason to think that half-hourly load from 2016/17 through to 2018/19 can provide useful information on potential load and price outcomes for 2020. While there is some indication that load in the middle of the day is falling slightly – likely as a result of increased solar PV generation – the effect does not appear to be significant. Our assessment suggests that under current market conditions, these changes in load (and, more broadly, the effect that solar PV has on load) would not have a material impact on our estimate of WEC. However, this will need to be monitored in future.

While there is little change in the average daily load profile, there have been more significant changes in price outcomes over the period 2016/17 through to 2018/19. In particular, the average daily profile for spot prices shows that the peak in spot prices in the mid-afternoon to evening period was more significant in 2018/19 than it was in earlier years, and persistent longer in the evening. This was primarily driven by high price events during the afternoon to evening period in summer 2018/19. What is more, the analysis of ASXEnergy data that we have undertaken – including as summarised in **Figure 8** – suggests that the market is expecting similar high price events to occur during Q1 2020. This suggests that the market is expecting that half-hourly prices in 2020 will be more like those in 2018/19 than in 2016/17 and 2017/18, and raises the question of whether only using half-hourly prices (and load) from 2018/19 to forecast half-hourly prices (and load) for 2020 would be preferable to including data from all three historical years in a Monte Carlo simulation.

For our draft report we used all three years of data in our Monte Carlo analysis, and in consultation we noted that only using the two most recent years would result in a higher WEC. Submissions from a number of retailers proposed using two years of data, while the submission from ACIL Allen Consulting for the Australian Energy Council noted that ACIL Allen Consulting generally shares the view that all three years of data should be used.

For this final report we continue to use all three years of data in our Monte Carlo analysis. While we note the concern that there has been a step change in outcomes in the market that suggests we should only use more recent market data, our view is that future outcomes remain uncertain, and using all three years of data in our Monte Carlo analysis reflects this future uncertainty.

3.3 Projecting half-hourly load and spot prices

Rather than take a single one of the years 2016/17, 2017/18 or 2018/19 as representative of outcomes in 2020, we perform a Monte Carlo simulation on the 3 years of half-hourly load and price data. In our view there are two benefits of using a Monte Carlo analysis:

- Any single year will be subject to unique market conditions that are unlikely to be repeated. This creates the risk that any single year may not be representative of conditions that might be expected in the future. However, using a Monte Carlo approach based, in this case, on 3 years of data increases the likelihood of basing our analysis on a representative set of conditions.
- Using a Monte Carlo analysis allows us to create a distribution of market conditions, providing some insight into the expected distribution of the WEC.

The potential benefits of the Monte Carlo approach increase over time as a longer time series of load data becomes available to the ESC.

The Monte Carlo simulation is used to generate a year of half-hourly data by randomly drawing one day of data, from the pool of available historical days, for each day of the forecast year. This random drawing of data is done from a pool of like days (where days are classified according to day type – weekday/weekend – and quarter). The Monte Carlo simulation is then performed 500 times to get a distribution of simulated years, which allows us to choose a simulated year from within this distribution to use in the modelling.

For example, a single simulated year will be generated as follows:

- The first day of 2020 is 1 January 2020, which is a Wednesday. Since this is a Wednesday in Q1, the half-hourly load and spot data for the first day of 2020 will determined by randomly drawing a day's half-hourly data from all the Q1 weekdays that occurred in 2016/17, 2017/18 and 2018/19.
- The second day of 2020 is 2 January 2020, which is a Thursday. Since this is a Thursday in Q1, the half-hourly load and spot data for the second day of 2020 will also be determined by randomly drawing a day's half-hourly data from all the Q1 weekdays that occurred in 2016/17, 2017/18 and 2018/19.
- And so on for the 365 days that make up 2020, having regard, for each day, to its type and its quarter.

This process is then repeated 500 times to generate 500 simulated years, each year made up entirely of historical outcomes in 2016/17, 2017/18 and 2018/19.

For each of these simulated years, load and prices are drawn at the same time (i.e. from the same historical day) so that the correlation between load and prices is maintained.

Once we have completed this Monte Carlo simulation, we make a last adjustment to the consumption data, normalising each of the simulated years to 1 GWh of annual consumption. This maintains the load shape and correlation between load and prices, but each year now has a uniform annual consumption.

We also make a further adjustment to the half-hourly spot prices. We consider that historical half-hourly spot prices provide the best source of information about patterns of half-hourly spot prices and how these are correlated with half-hourly load, but historical spot prices are not necessarily a good predictor of the future average level of Victorian spot prices. There is no reason, for instance, that Victorian spot prices over the period 1 July 2016 to 30 June 2017 will, on average, be the same as Victorian spot prices for 2020. In our view, the best available public information about the average level of Victorian spot prices for 2020 is the contract prices published by ASXEnergy. These contract prices – particularly the prices of base swaps – provide the market's view on what will be the average spot price for 2020. Given this, for each simulated year, we assume that the average level of prices is consistent with ASXEnergy futures prices. Specifically, for each simulated year we scale the half-hourly prices so that the time-weighted average price in each quarter is equal to the relevant quarterly base swap prices for 2020 from ASXEnergy[5] (less an assumed contract premium of 5 per cent on the underlying prices)[6]. We use the 40-day average of ASXEnergy contract prices for quarterly base swap prices (up to 25 October 2019) as representing the market's current view of spot prices for each quarter of 2020.[7] This approach to generating half-hourly price forecasts results in:

[5] An alternative approach would be to attempt to scale half-hourly prices having regard to each of base swaps, peak swaps and cap prices. However, the scaling process would require subjective judgements about how to simultaneously scale to each of these prices. Given there would be little on which to base these subjective judgements our preference is to scale only to base swap prices, which is a mechanical process. We note, however, that the calculation of the WEC does use each of the contract prices from ASXEnergy.

[6] The contract premium cannot be directly observed, since it is the difference between an *expectation* at a point in time of future spot prices (which cannot be observed) and the observed forward contract prices at that point in time. However, by comparing data on out-turn spot prices and observed forward contract prices, an indication of the contract premium can be inferred. There will be significant volatility in this observed data point, because unexpected changes in market conditions will affect out-turn spot prices but not observed forward contract prices. Nevertheless, if this comparison is made over enough observations, an estimate of the contract premium can be developed. We have undertaken this analysis for the full set of data since the commencement of trade on ASXEnergy; based on that analysis, we consider that an assumption of a contract premium of 5% is reasonable. In its report for the Australian Energy Council, ACIL Allen recommended that "the appropriate level of contract premium is an outcome of the analysis rather than an input". We are unsure how this can be implemented and believe it would be incorrect to do so in any case. As discussed, the actual contract premium is by nature an unobservable value theoretically derived through comparing an expected outcome at a point in time to the observed outcome at the same point in time.

[7] We note that there is a difference in the averaging period that we use for estimating spot prices for 2020 and the averaging period we use for calculating contract prices to be used in estimating the WEC for the VDO. As discussed, we use the most recent 40-day average ASXEnergy prices as the best guide to the market's view on spot prices that will occur in 2020. However, based on instructions from the ESC, we use 12-month trade weighted average ASXEnergy prices to set the contract

- The appropriate average *level* of spot prices (i.e. the time-weighted quarterly average price is consistent with ASXEnergy prices).
- The appropriate *half-hourly profile* of spot prices (i.e. the half-hourly profile of prices, and load, are consistent with historical outcomes).

Response to submissions

In its report for the Australian Energy Council, ACIL Allen Consulting stated that scaling each of the historical years to ASXEnergy prices "prior to undertaking the Monte Carlo analysis would more appropriately represent the uncertainty of wholesale electricity spot price outcomes". We do not believe this is a preferable approach, as the uncertainty is captured in the differing load weighted prices resulting from the Monte Carlo analysis. As well, we believe that the best information available about prices next year are from the prices of base swaps on ASXEnergy, so utilising these by scaling to them for all years more accurately fits the market's expected outcome.

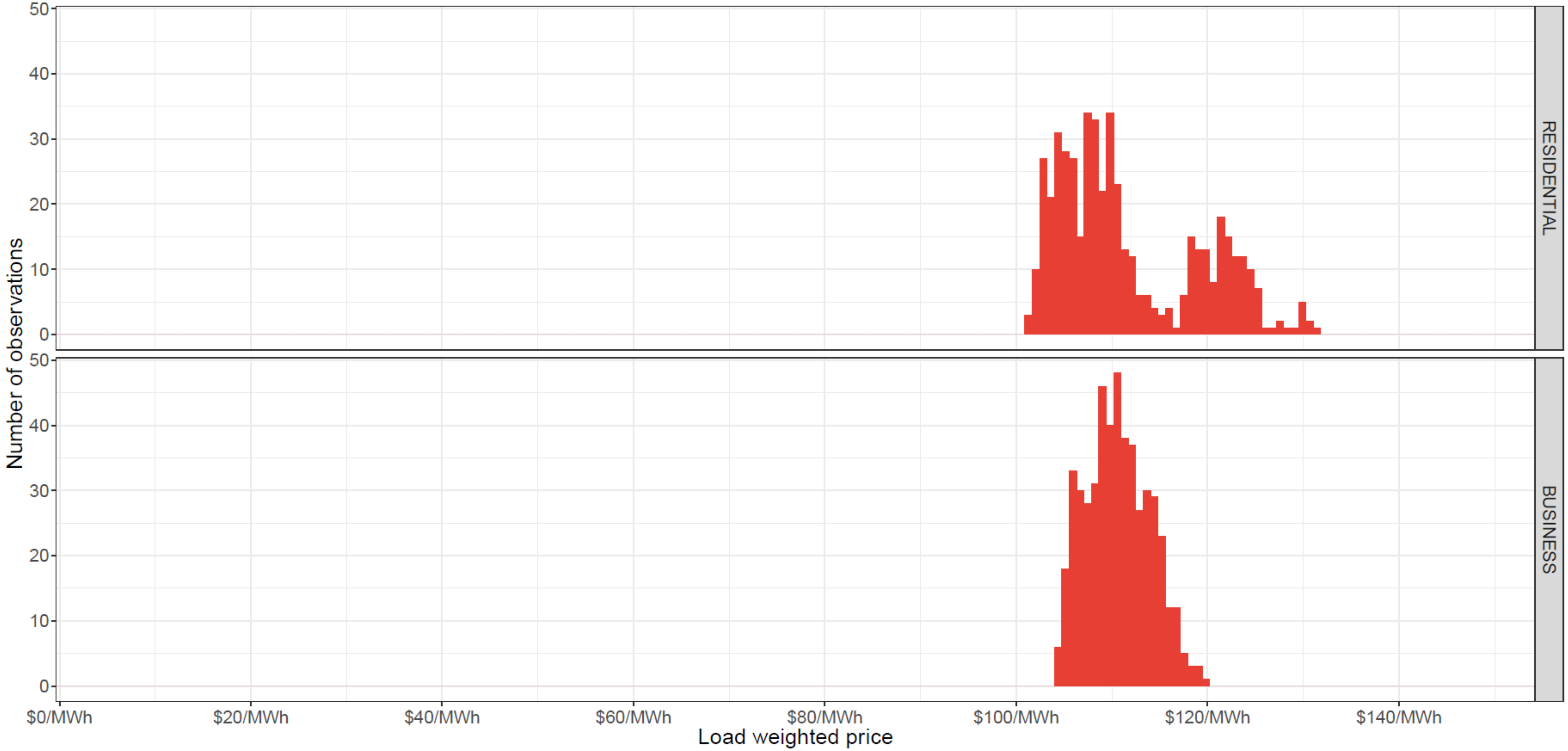
Analysis of data

An indication of the results of this Monte Carlo simulation can be provided by calculating the load-weighted price for each of the 500 simulated years. As we discussed, in our experience the load-weighted price is a reasonable guide to the WEC. **Figure 10** through **Figure 14** show the distribution of load-weighted prices for each of the 500 simulated years from our Monte Carlo analysis, for each distribution area and for each customer type. As discussed, the average spot price in each of these simulated years is the same – based on the 40-day average ASXEnergy base swap price – but the half-hourly profile of both spot prices and load are different. It should be clear from **Figure 10** through **Figure 14** that the Monte Carlo simulation has resulted in a distribution of load-weighted prices driven by differences in the half-hourly patterns of spot prices and load.

Submissions from some stakeholders have raised the point that this Monte Carlo process is not transparent. We acknowledge that we have not released the Monte Carlo model that generates prices and load for simulated years based on historical data. However, we consider that the process is reasonably transparent: the sequence of half-hourly prices and load that we use to calculate the WEC are simply a random sequence of days drawn from 2016/17, 2017/18 and 2018/19, with prices scaled to match the ASX forward curve, using the process we described above. We have not forecast load or prices, but merely drawn from recent history. Furthermore, as well as the summary data on load-weighted prices that are presented in **Figure 10** through **Figure 14**, we have released a spreadsheet for each distribution area that contains the full set of half-hourly load and price data for the median simulated year that we have used to calculated the WEC.

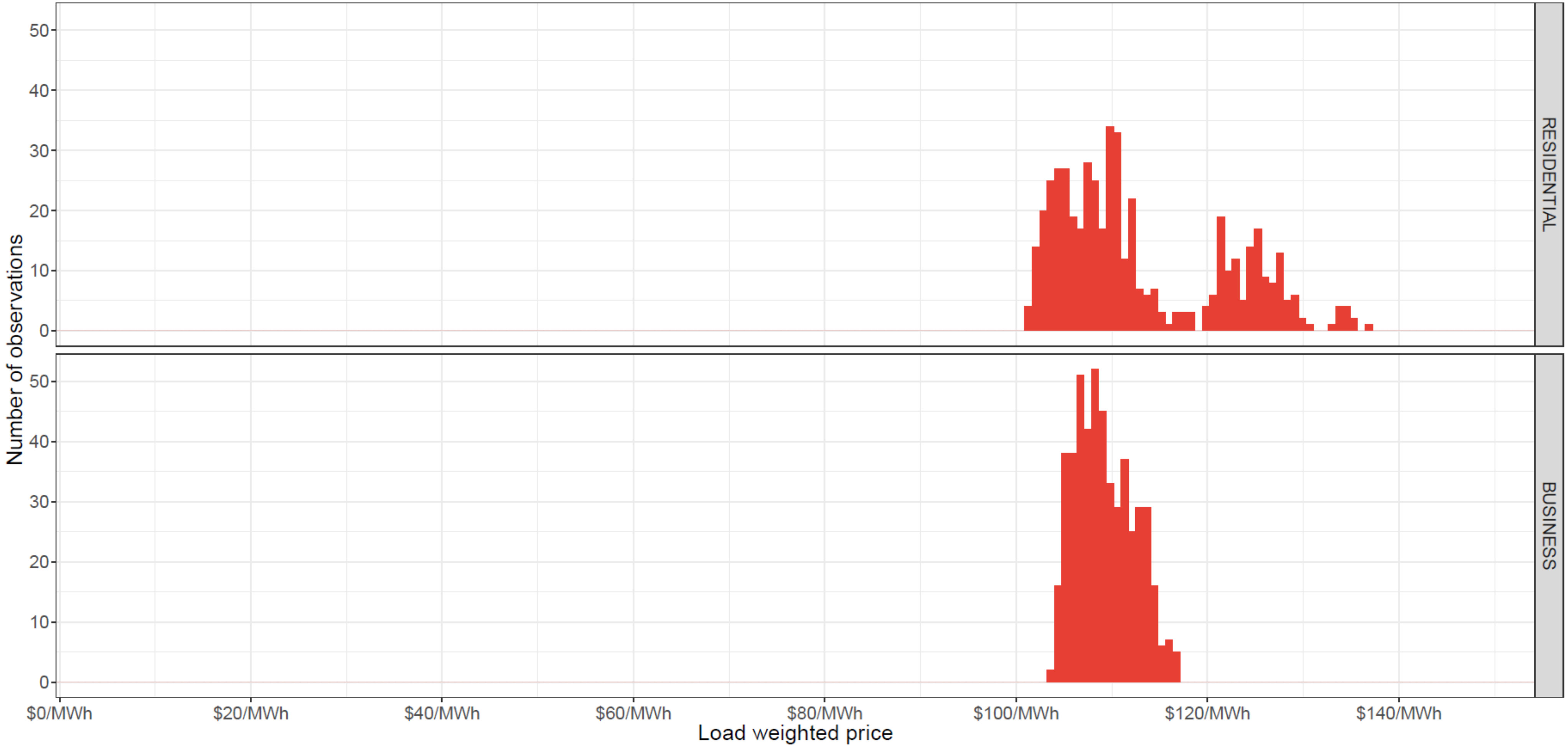
price for retailers when determining the WEC. In our view, there is no necessity for these averaging periods to be consistent. One way to think about the WEC that we are calculating using this approach is that we are estimating the contract payments that a retailer would face if that retailer had purchased its contracts for 2020 over the last 12 months (at the same time as trade occurs on ASXEnergy) and uses those contracts to hedge the risk it would face based on current expectations of spot prices.

Figure 10: Distribution of load-weighted price for simulate d years for residential and business load – CitiPower



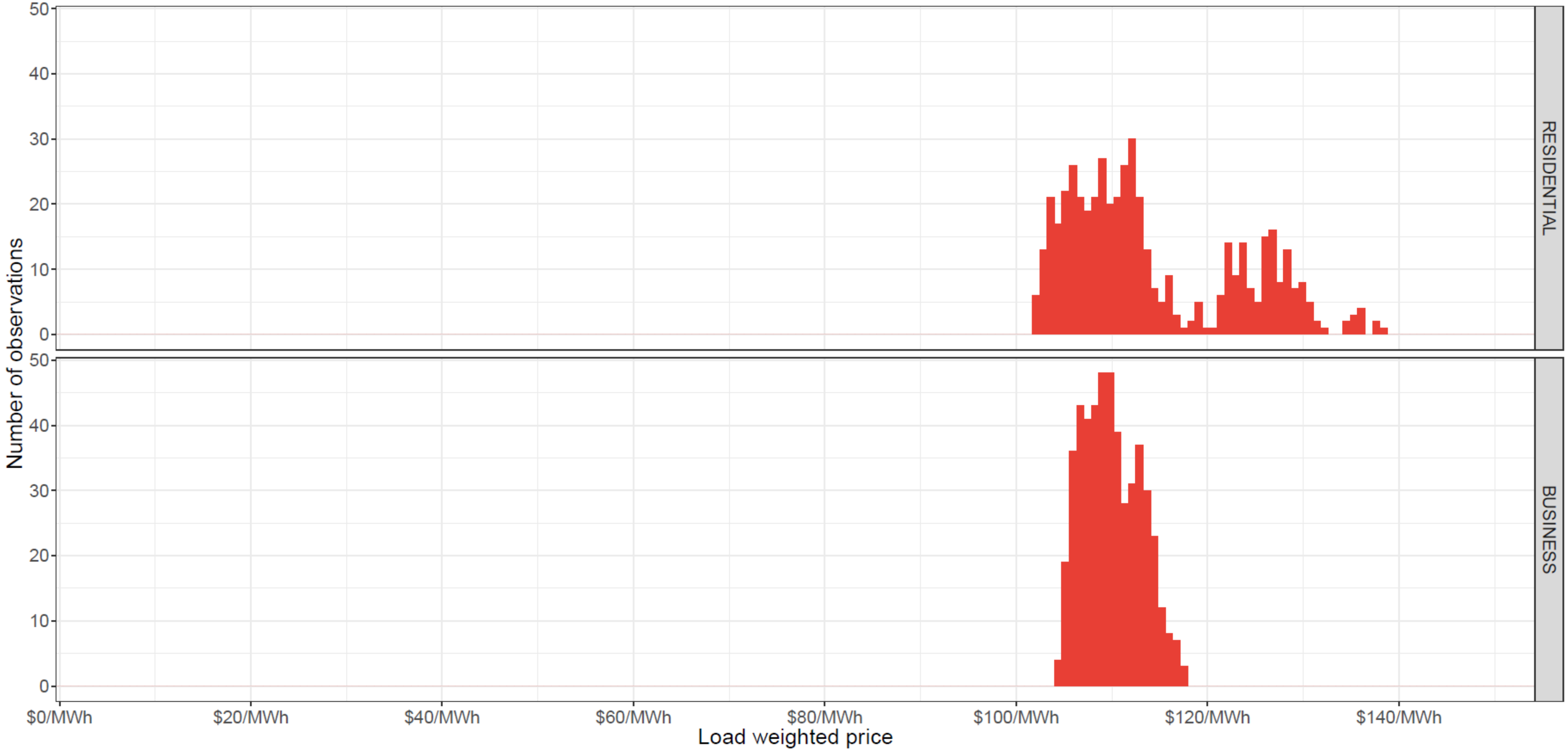
Source: Frontier Economics

Figure 11: Distribution of load-weighted price for simulated years for residential and business load – Powercor



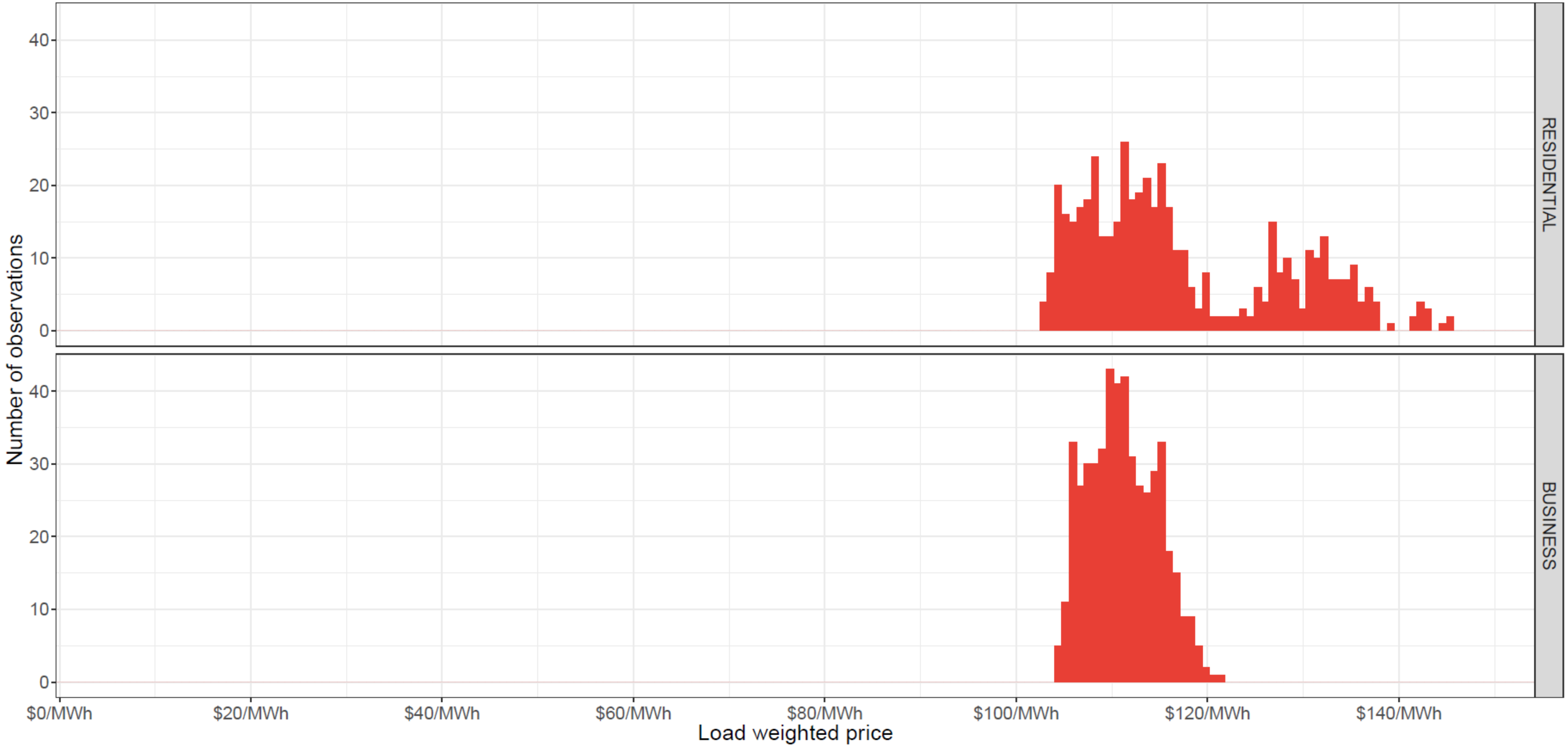
Source: Frontier Economics

Figure 12: Distribution of load-weighted price for simulated years for residential and business load – AusNet



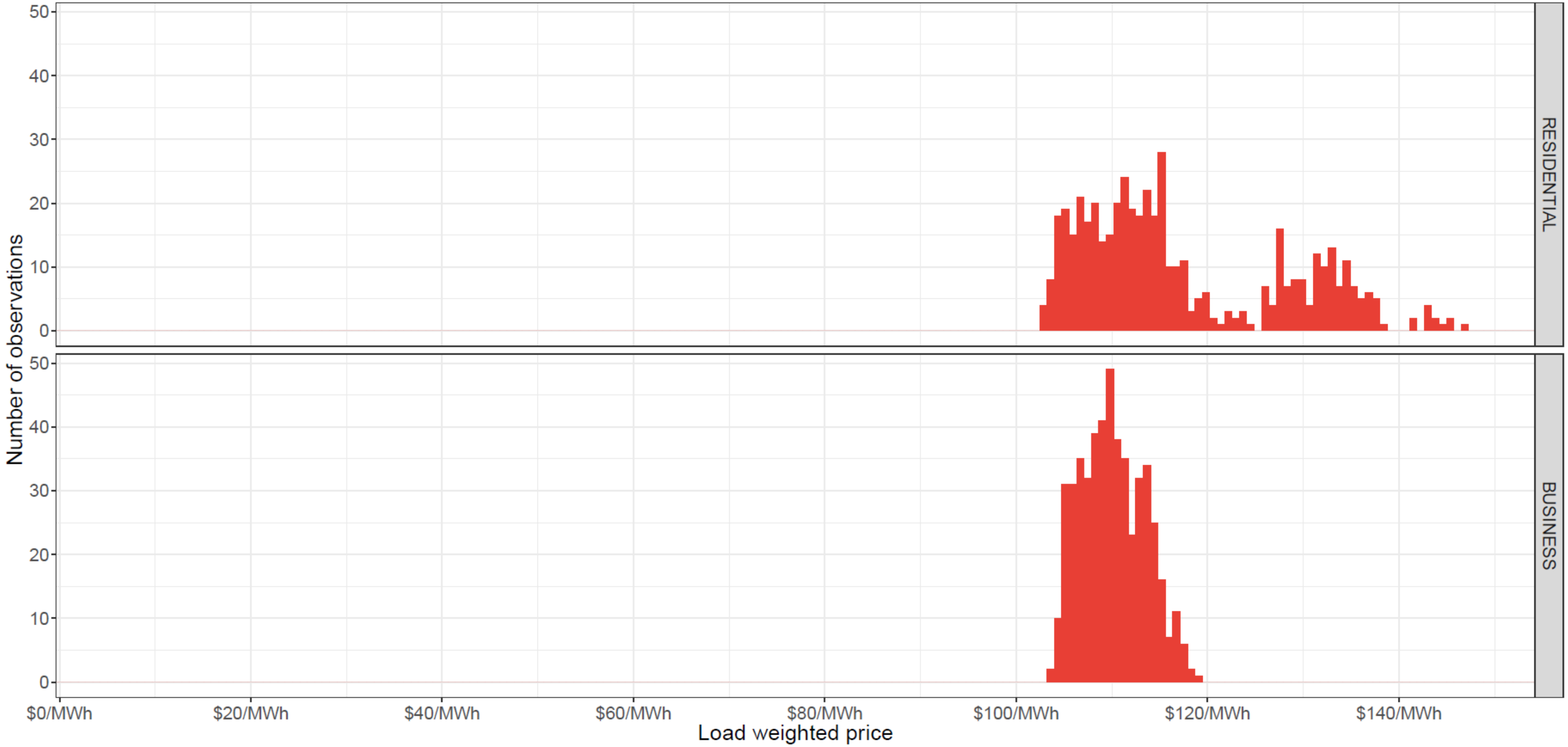
Source: Frontier Economics

Figure 13: Distribution of load-weighted price for simulated years for residential and business load – United



Source: Frontier Economics

Figure 14: Distribution of load-weighted price for simulated years for residential and business load – Jemena



Source: Frontier Economics

4 CONTRACT PRICES

This section addresses the third question we need to answer to estimate WEC:

- What is the cost of financial hedging contracts?

As discussed, our approach to assessing the WEC that retailers face is based on an estimate of the cost that a prudent retailer would face in supplying electricity to their customers, having regard to the hedging contracts that a prudent retailer is likely to enter into. The hedging contracts that we base this analysis on are ASXEnergy contracts. There are three main types of electricity contracts that are traded on ASXEnergy:

- Base swaps for each quarter.
- Peak swaps for each quarter.
- Base $300 caps for each quarter.

These contracts trade for a number of years in advance. Prices are published by ASXEnergy for each contract for each trading day.

Figure 15 through **Figure 17** set out the relevant trading data for each of these three contract types, for each quarterly product. The trading data that is presented is open interest (which measures the total volume of contracts in the market), the settlement price and the trading volume.

We can see from **Figure 15** through **Figure 17** that most contracts for calendar year 2020 are currently trading regularly. In particular, we can see that trade in base swaps and caps is occurring on most trading days. This suggests that the daily prices for base swaps and caps does provide a genuine indication of the market's view of future prices. However, trade in peak swaps is a lot lower than base swaps and caps, which raises the prospect that the available prices for peak swaps for calendar year 2020 may not represent the market's current view of likely price outcomes for 2020. While there is some risk to this, we would note that the relative level of peak swap prices, compared to base swap prices, is consistent with what we would generally expect. We also note that peak swaps generally form part of our estimate of an efficient portfolio of contracts, and excluding these from the analysis risks understating the costs that retailers face in hedging the higher load that they tend to face during peak periods.

Our view is that economic decisions in competitive markets will be based on the market value of contracts (and we consider 40-day average prices are a good proxy for this market value), regardless of when those contracts are purchased. If a retailer has purchased contracts in the past at prices above the current market price, we would expect that competition from existing or new entrant retailers would force the retailer to make retail price offers based on the current cost of purchasing contracts; to do otherwise would be to risk losing customers to competitors able to enter or expand by purchasing contracts at the current cost and making retail price offers based on those current costs. Similarly, if a retailer has purchased contracts in the past at prices below the current market price, we would expect that maximising shareholder value would require them to make retail price offers based on the current cost of purchasing contracts; making retail price offers based on lower historical contract costs would result in less profit than simply selling the contracts again at the current contract price. We have not changed our view on this: we believe that market forces will result in retailer's pricing decisions being based on the current value of contracts in a competitive market.

However, there may be good reasons that a regulator will choose to base regulated prices on something other than 40-day average contract prices. For instance, a longer averaging period, such as 12 months or 24 months, would be expected to provide regulated prices that are more stable over time and would also likely result in regulated prices that are more reflective of incumbent retailers' actual historical costs (since most retailers will buy contracts over a number of years leading up to the year). The ESC has asked us to use 12-month trade weighted contract prices in estimating the WEC. We calculate the 12-month trade weighted contract price for each contract by taking an average of the daily settlement price for that contract over the last 12 months, but weighting each daily settlement price by the share of the total volume of trade over the last 12 months that happened on that day. This means that the settlement price on a day on which no trade occurred is given a weighting of zero in calculating the 12-month trade weighted contract price, while the settlement price on the day on which the most trades occurred in the last 12 months is given the highest weighting.

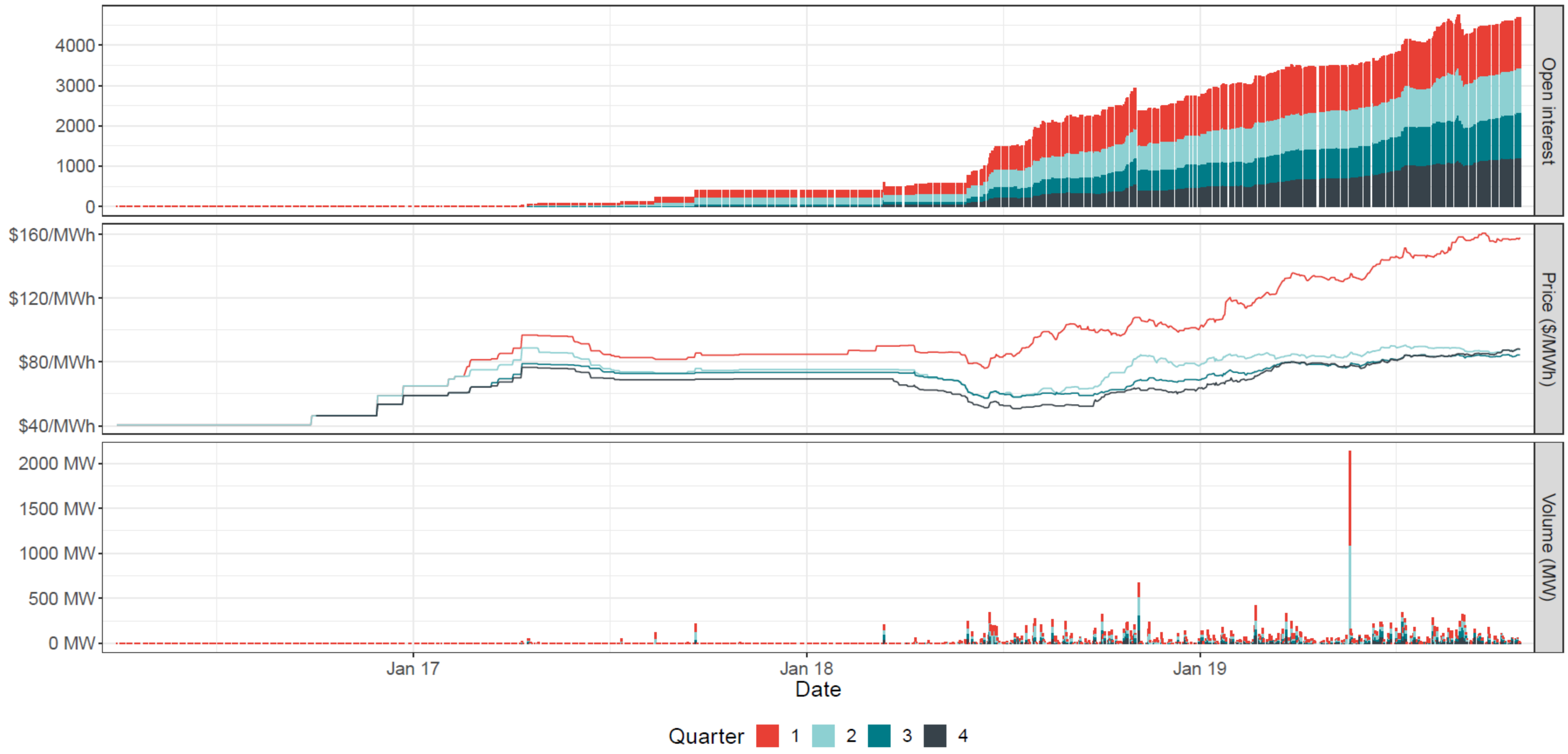
ASXEnergy contract prices are shown in **Table 1**, for the 12-month trade weighted average price, up to 25 October 2019.

Table 1: 12-month trade weighted average ASXEnergy derivative prices for Victoria

	PRODUCT	STATUS	CALENDAR YEAR	QUARTER			
				Q1	Q2	Q3	Q4
TRADE WEIGHTED	$300 Caps	Base	2020	$39.81	$3.26	$3.50	$6.37
	Swaps	Base	2020	$130.45	$85.19	$78.57	$77.50
	Swaps	Peak	2020	$193.47	$100.70	$94.71	$96.44

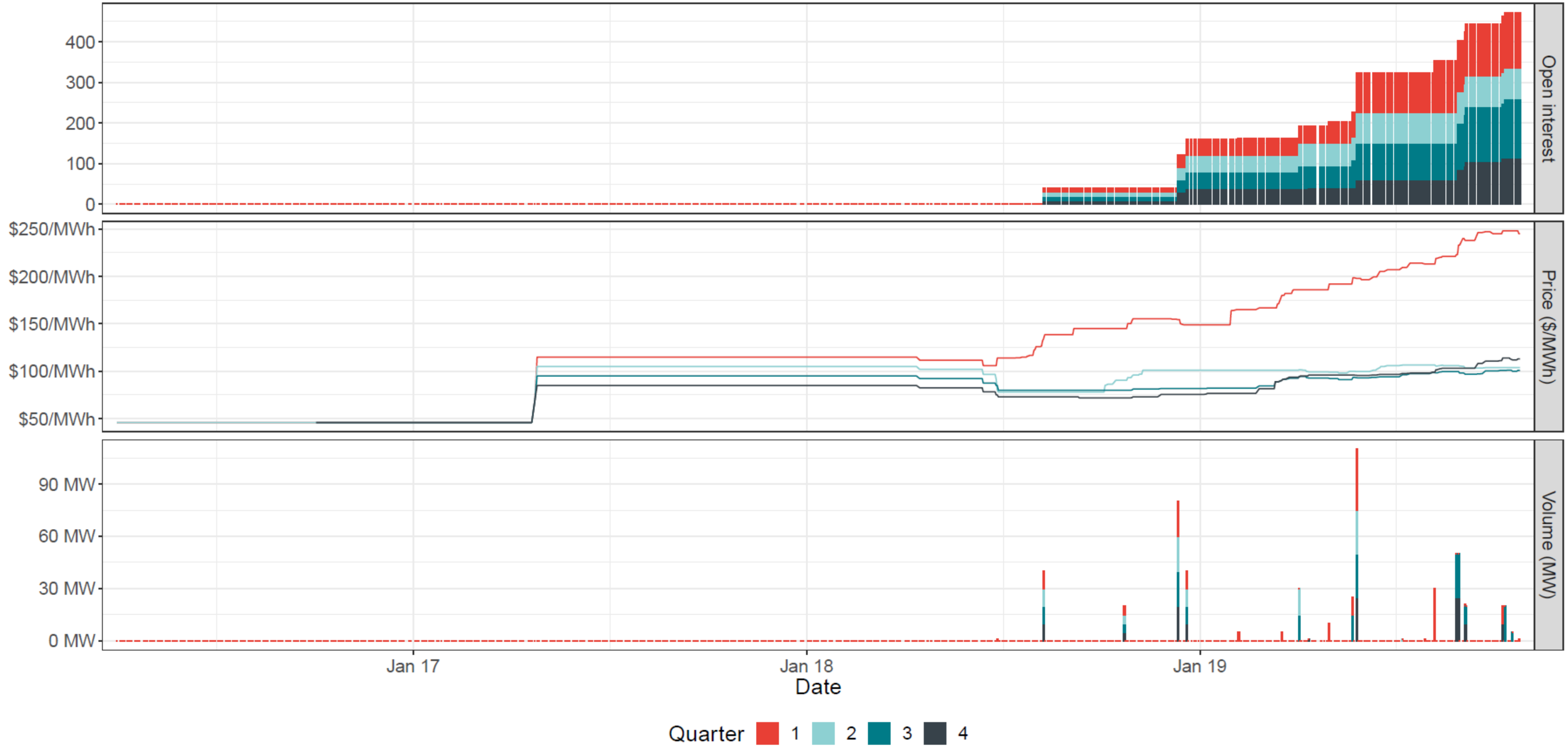
Source: Frontier Economics analysis of ASXEnergy data

Figure 15: Victorian base swaps – open interest, prices and volumes for calendar year 2020



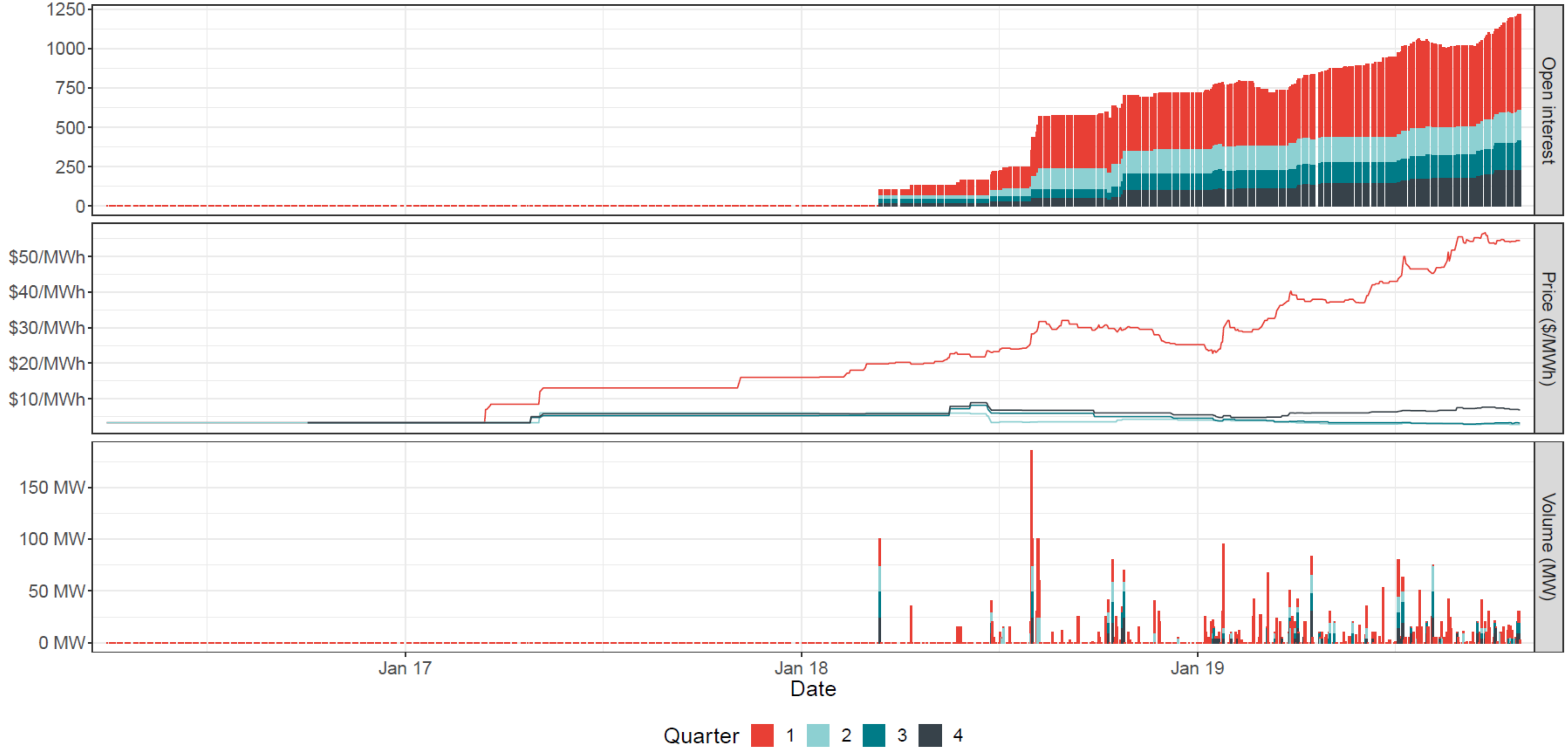
Source: Frontier Economics analysis of ASX data

Figure 16: Victorian peak swaps – open interest, prices and volumes for calendar year 2020



Source: Frontier Economics analysis of ASX data

Figure 17: Victorian base $300 caps – open interest, prices and volumes for calendar year 2020



Source: Frontier Economics analysis of ASX data

5 CONTRACT POSITION

This section addresses the final question we need to answer to estimate WEC:

- What kind of hedging position is a prudent retailer likely to adopt?

We use our portfolio optimisation model – *STRIKE* – to determine the efficient mix of hedging products that a prudent retailer would likely adopt. *STRIKE* calculates an efficient frontier, which represents the contracting positions that provide the lowest energy purchase cost for a given level of risk (as measured by standard deviation).

STRIKE applies a Minimum Variance Portfolio (MVP) approach to the task of hedging a retailer's exposure to wholesale spot prices. *STRIKE* incorporates an estimate of a retailer's exposure to the wholesale spot market, which is determined by the retailer's load and wholesale spot prices. There is an expected return and a variance associated with this. *STRIKE* also incorporates the types of hedging products that are typical in the electricity industry. These contracts – swaps and caps – generate cashflows that also have an expected return and a variance. Instead of assessing the expected return and associated risk for each asset in isolation, *STRIKE* applies the concepts of portfolio theory to evaluate the contribution of each asset to the risk of the portfolio as a whole. Based on this approach, *STRIKE* calculates efficient hedging strategies.

In order to determine a hedging position for the purposes of estimating the WEC for each customer type in each distribution area in Victoria, we make use of the following inputs in *STRIKE*:

- Forecast spot prices and load, as discussed in Section 3. As we discussed, we have developed 500 simulated years of half-hourly spot prices and load for 2020. There is a distribution of outcomes within these 500 simulated years. Our view is that an efficient retailer's hedging position should have regard to the uncertainty associated with what kind of year 2020 will be; will 2020 be a year with high prices and high load corresponding, so that the load-weighted price is high, or will 2020 be a year with low prices and high load corresponding, so that the load-weighted price is low? To account for this uncertainty, we input 7 simulated years into *STRIKE*, representing those simulated years that represent the 99^{th}, 95^{th}, 75^{th}, 50^{th}, 25^{th}, 5^{th} and 1^{st} percentile when the 500 simulated years are ranked according to load-weighted price.

- Contract prices, as discussed in Section 4. We present results for 12-month trade weighted contract prices.

As discussed, *STRIKE* calculates an efficient frontier, which represents the contracting positions that provide the lowest energy purchase cost for a given level of risk. The contract position that we use to calculate the WEC is based on the most conservative contracting position on the efficient frontier, which is the point on the efficient frontier with the lowest risk (but highest cost).

Outlined in **Figure 18** to **Figure 27** are the resulting contract positions at the conservative point for 2020, for each load profile and for each distribution area. For each quarter (the vertical panels) and each peak/off-peak period (the horizontal panels), the charts show the following:

- The distribution of half-hourly load for the 48 half-hours of the day (shown by the box plots in the 'Load' panel).

- The distribution of half-hourly spot prices for the 48 half-hours of the day (shown by the box plots in the 'Spot price' panel). The price chart is truncated at a spot price of $750/MWh.

- The quantity of swaps and caps at the conservative point of the efficient frontier (shown by the coloured areas in the 'Load' panel).

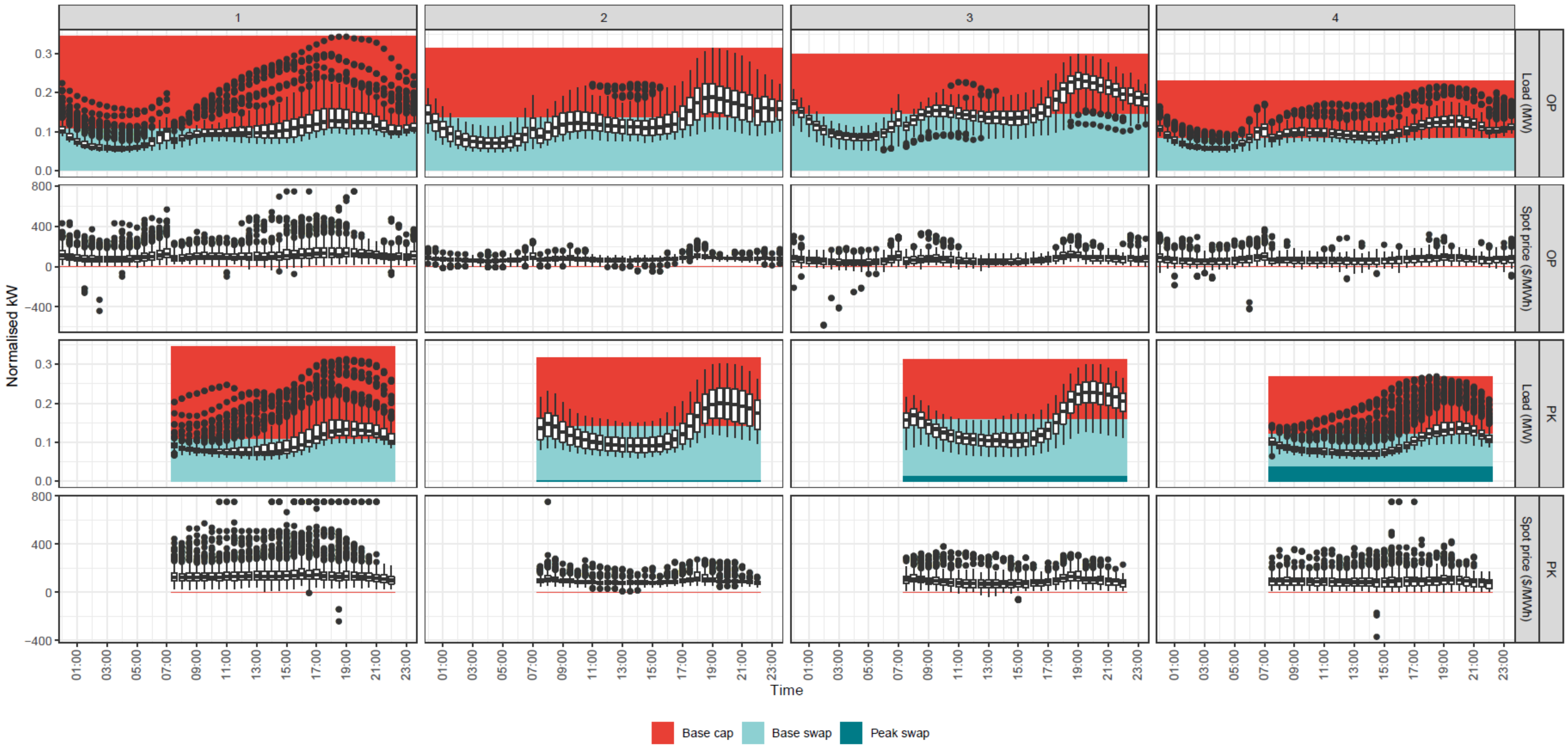
In general, the contract position at the conservative point involves:

- purchasing swaps to cover (approximately) average demand
- purchasing caps, on top of that, to cover (approximately) to peak demand
- in some cases, incurring a small amount of pool exposure at absolute peak demand times.

As seen in **Figure 18** to **Figure 27**, the contract position at the conservative point does not always result in complete coverage of the highest demand half hours. The reason that there can remain some residual pool exposure even at the conservative point is that *STRIKE* balances the costs and risks of remaining exposed to the spot price at these highest demand half hours against the costs and risks associated with being over-contracted. Signing additional contracts is neither costless nor riskless, and while being exposed to the spot price during a small number of high demand half-hours can result in large payments, being over-contracted for a large number of lower demand half-hours can also result in large payments. Some retailers may have a preference for additional contract cover to meet forecast peak demand in all cases, but we note that the volatility allowance (discussed in Section 6.2) is intended to reflect the residual risk at the conservative point and could be used to purchase additional cap cover.

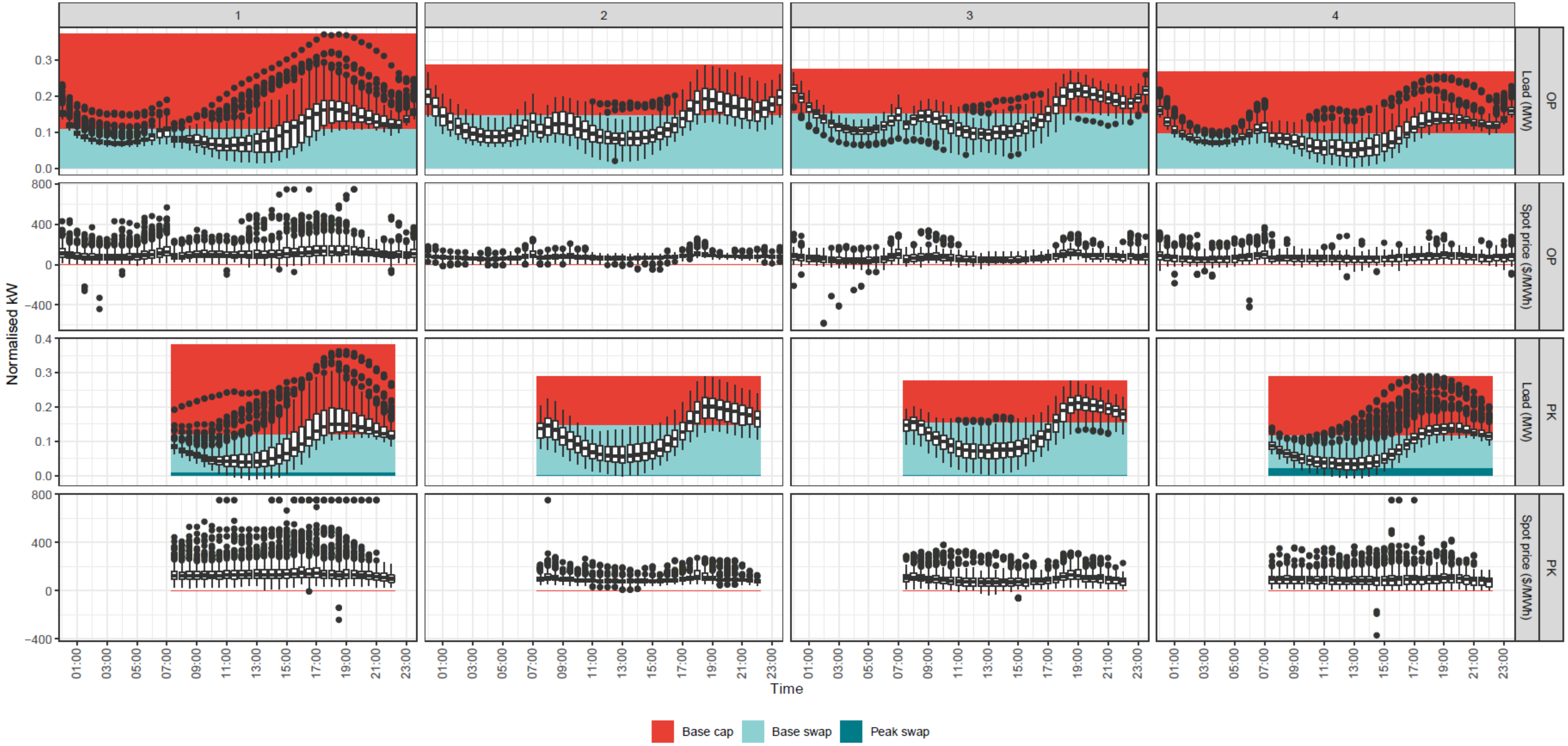
It should also be noted that the conservative point on the efficient frontier reflects the contract position that achieves the lowest risk given the projected state of the world that is input into *STRIKE*. In the event that different states of the world were input into *STRIKE*, the model would find a different contract position that achieves the lowest risk. In particular, if it were assumed, for instance, that next year will have an unusually large number of very high price events that coincided with high load, then the model would certainly find a different contract position that achieves the lowest risk. That load forecasts and price forecasts (and their correlation) are important to the costs that retailers face in supplying regulated customers is why we use the best available information to develop load forecasts and price forecasts that are consistent with the observed peakiness of historic load and historic prices (and the observed correlation between them).

Figure 18: Contract position for CitiPower residential load, ASXEnergy contract prices, calendar year 2020 (2020 dollars)



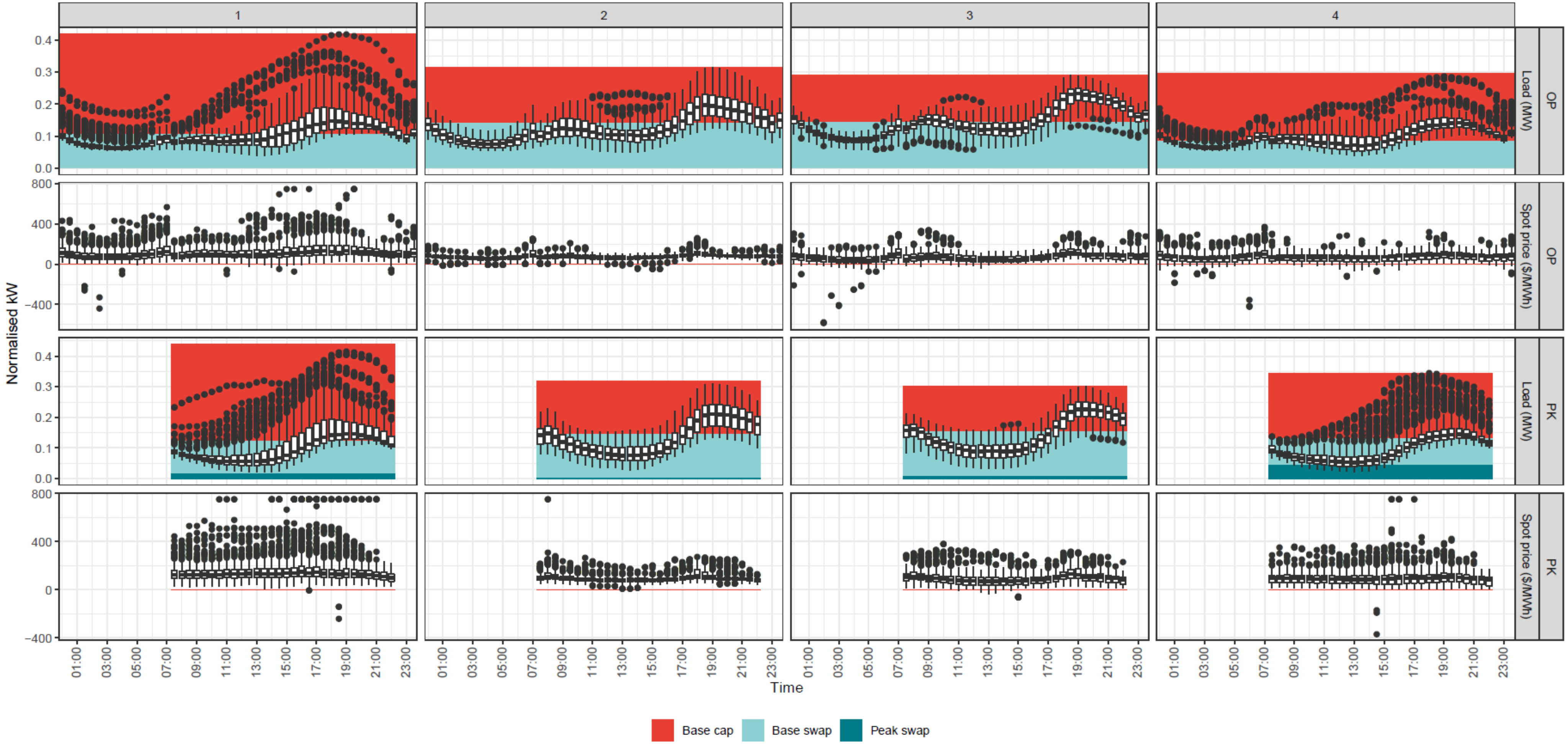
Note: Spot price chart truncated at a spot price of $750/MWh.

Figure 19: Contract position for Powercor residential load, ASXEnergy contract prices, calendar year 2020 (2020 dollars)



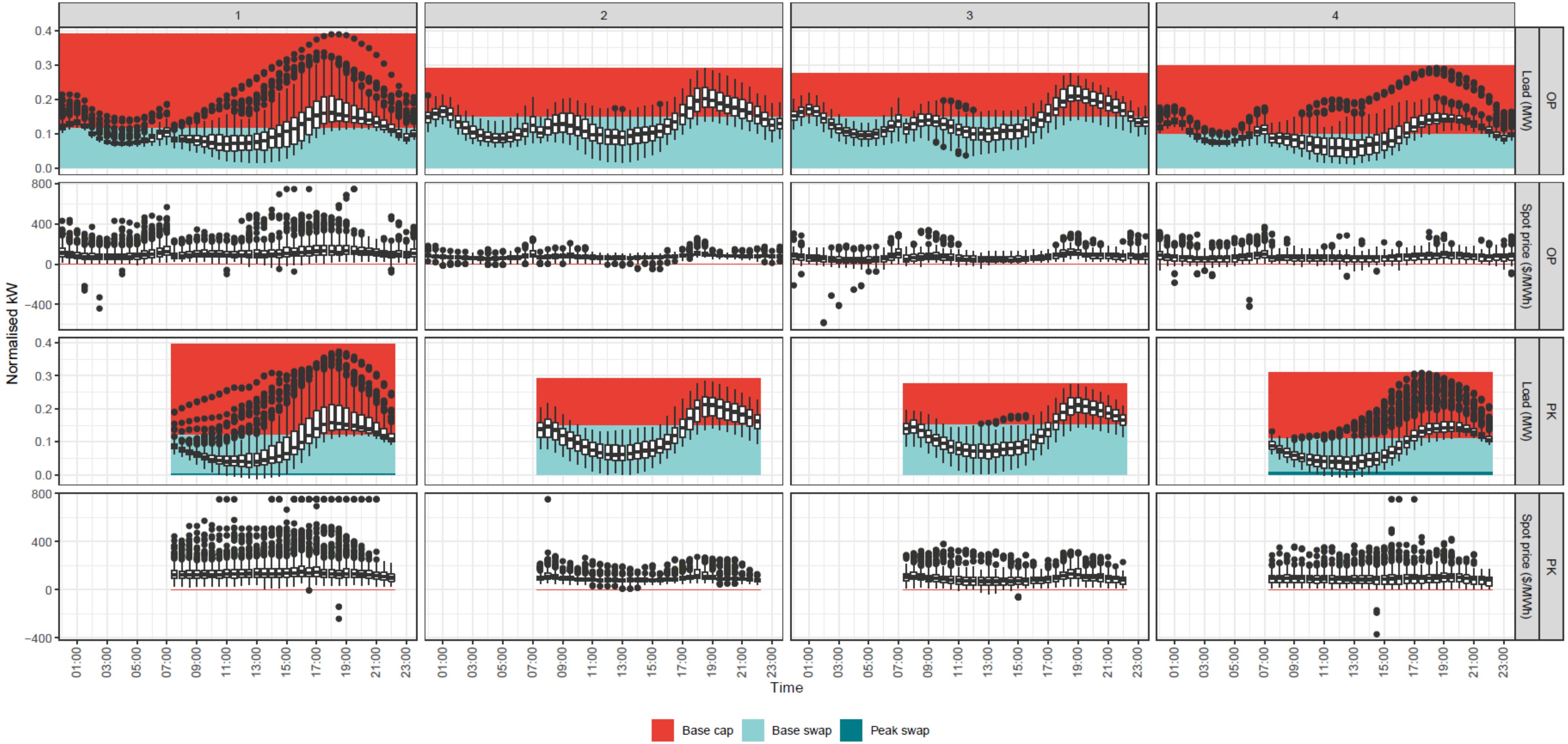
Note: Spot price chart truncated at a spot price of $750/MWh.

Figure 20: Contract position for Jemena residential load, ASXEnergy contract prices, calendar year 2020 (2020 dollars)



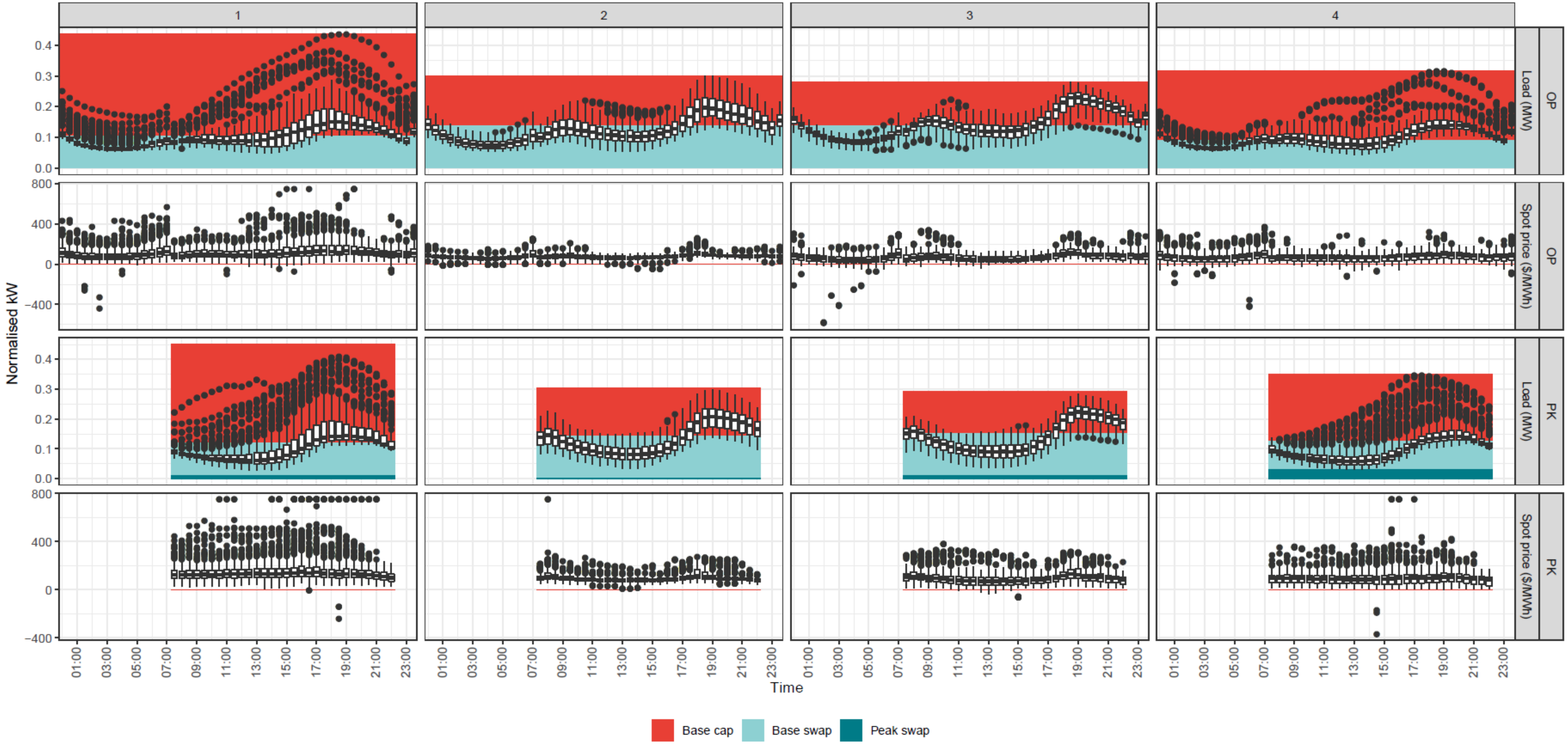
Note: Spot price chart truncated at a spot price of $750/MWh.

Figure 21: Contract position for AusNet residential load, ASXEnergy contract prices, calendar year 2020 (2020 dollars)



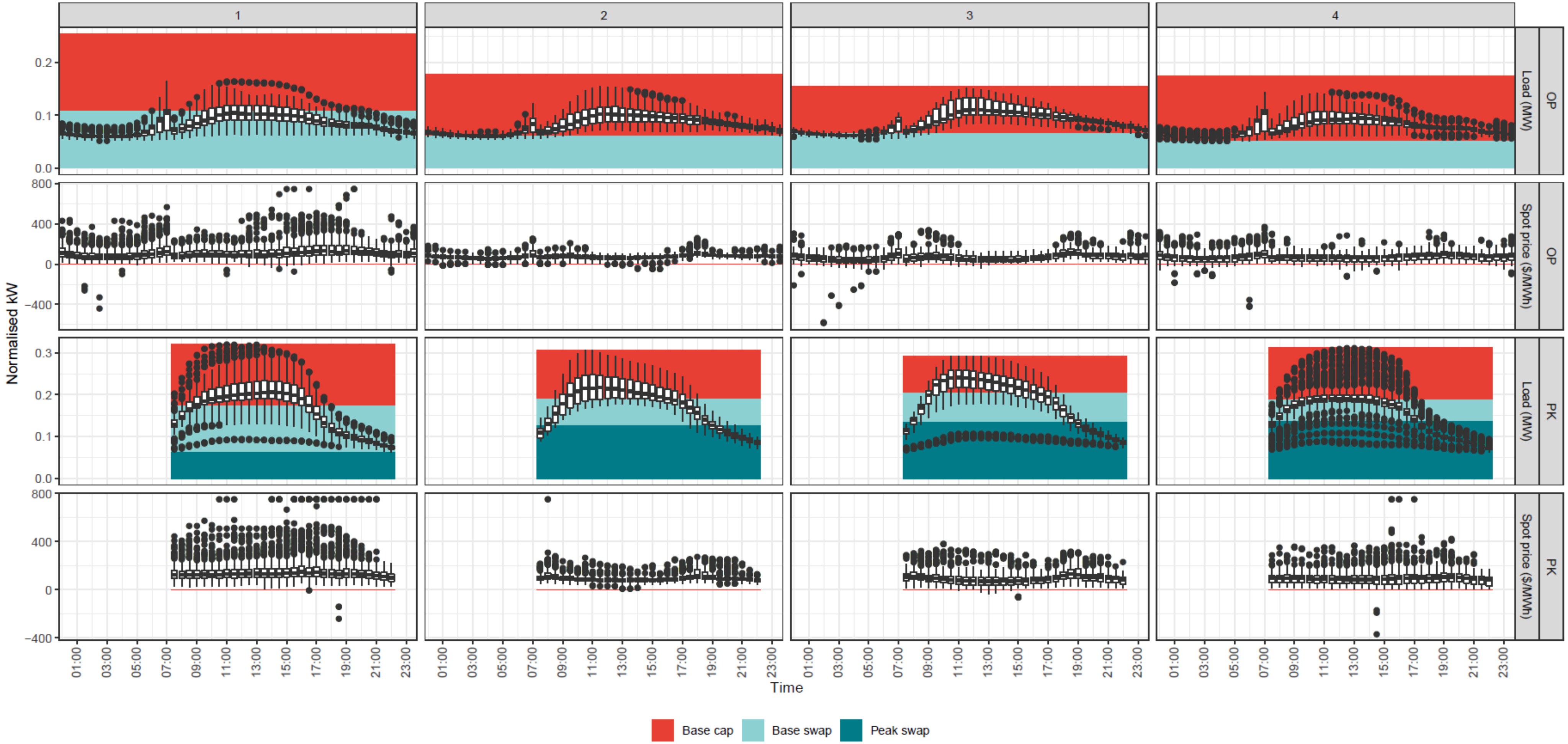
Note: Spot price chart truncated at a spot price of $750/MWh.

Figure 22: Contract position for United residential load, ASXEnergy contract prices, calendar year 2020 (2020 dollars)



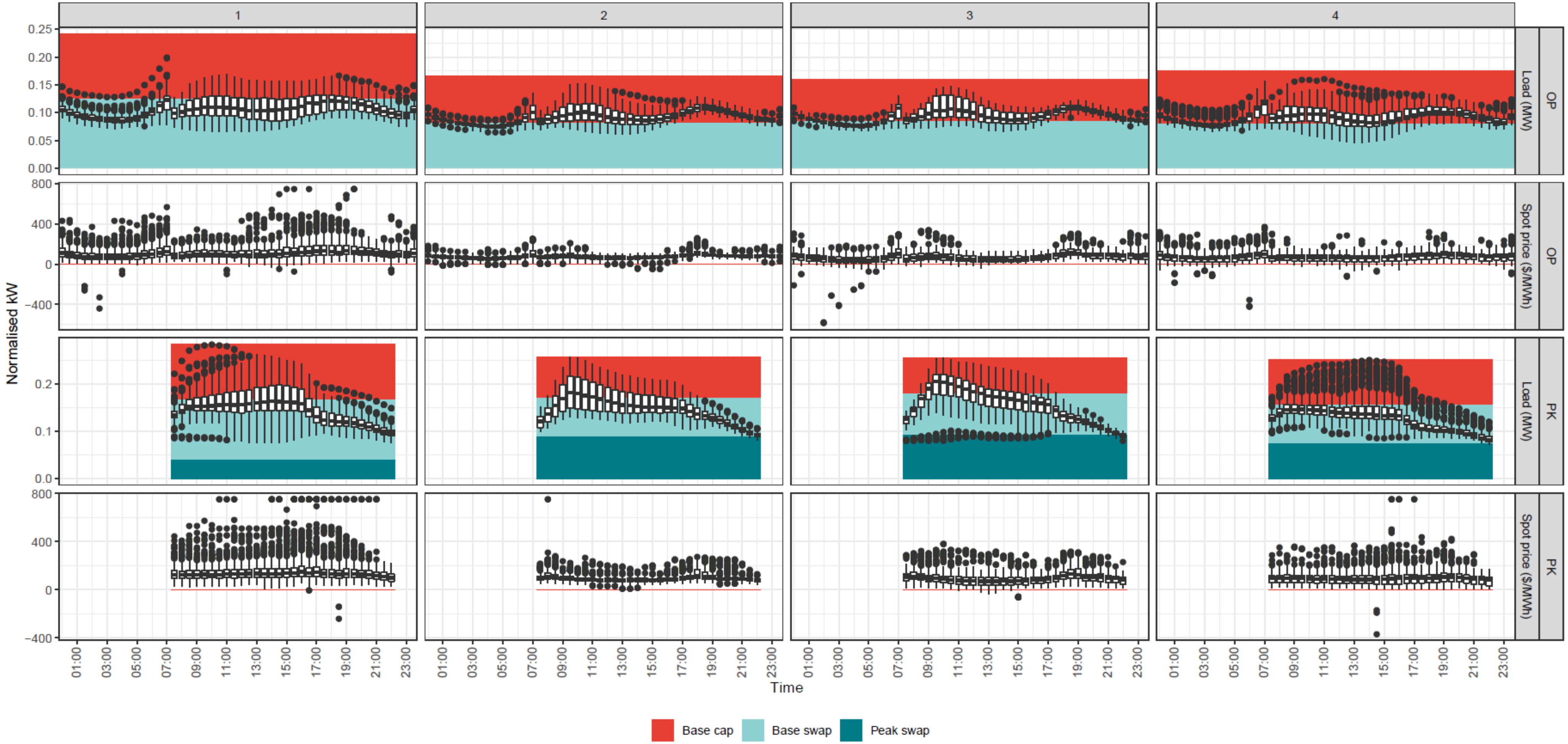
Note: Spot price chart truncated at a spot price of $750/MWh.

Figure 23: Contract position for CitiPower business load, ASXEnergy contract prices, calendar year 2020 (2020 dollars)



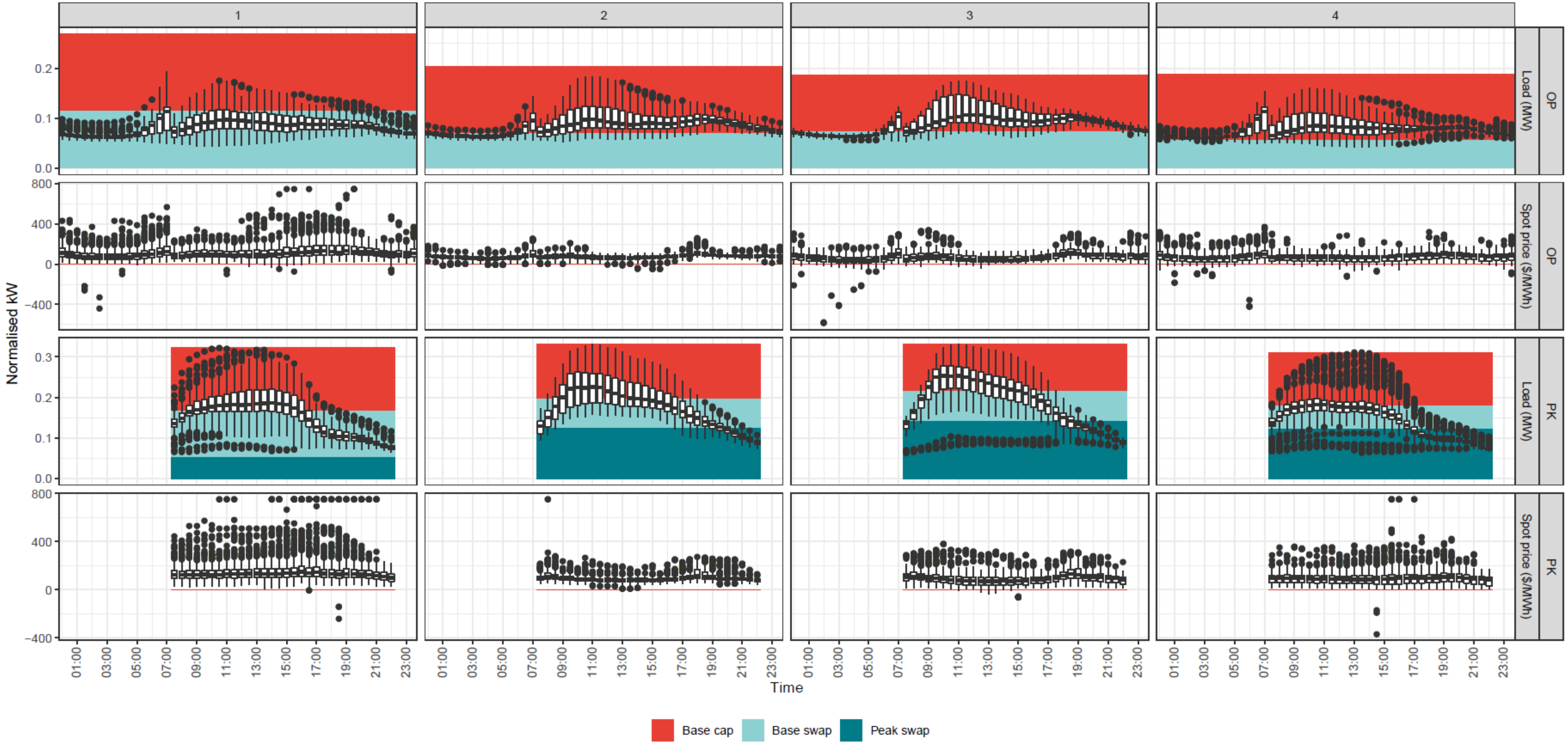
Note: Spot price chart truncated at a spot price of $750/MWh.

Figure 24: Contract position for PowerCor business load, ASXEnergy contract prices, calendar year 2020 (2020 dollars)



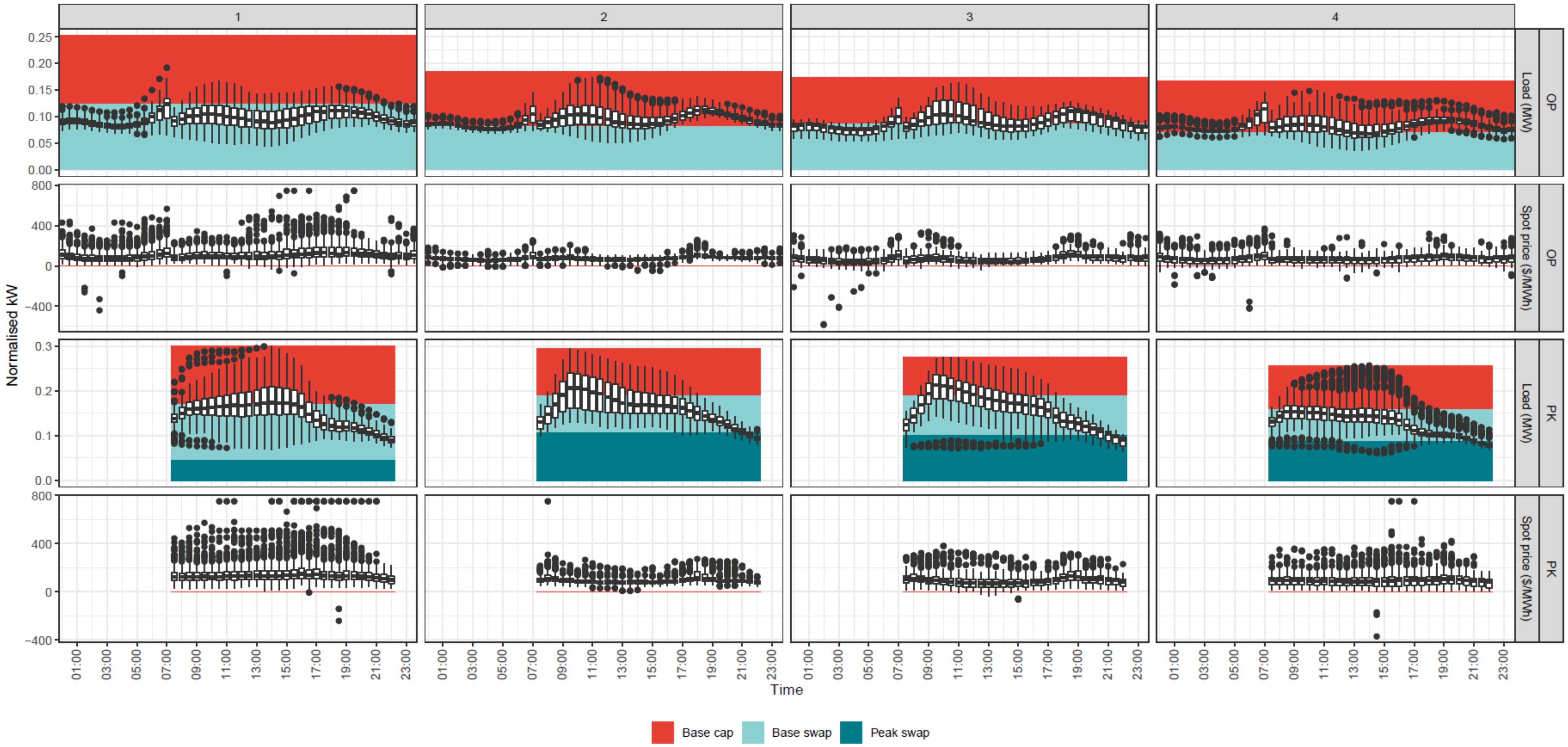
Note: Spot price chart truncated at a spot price of $750/MWh.

Figure 25: Contract position for Jemena business load, ASXEnergy contract prices, calendar year 2020 (2020 dollars)



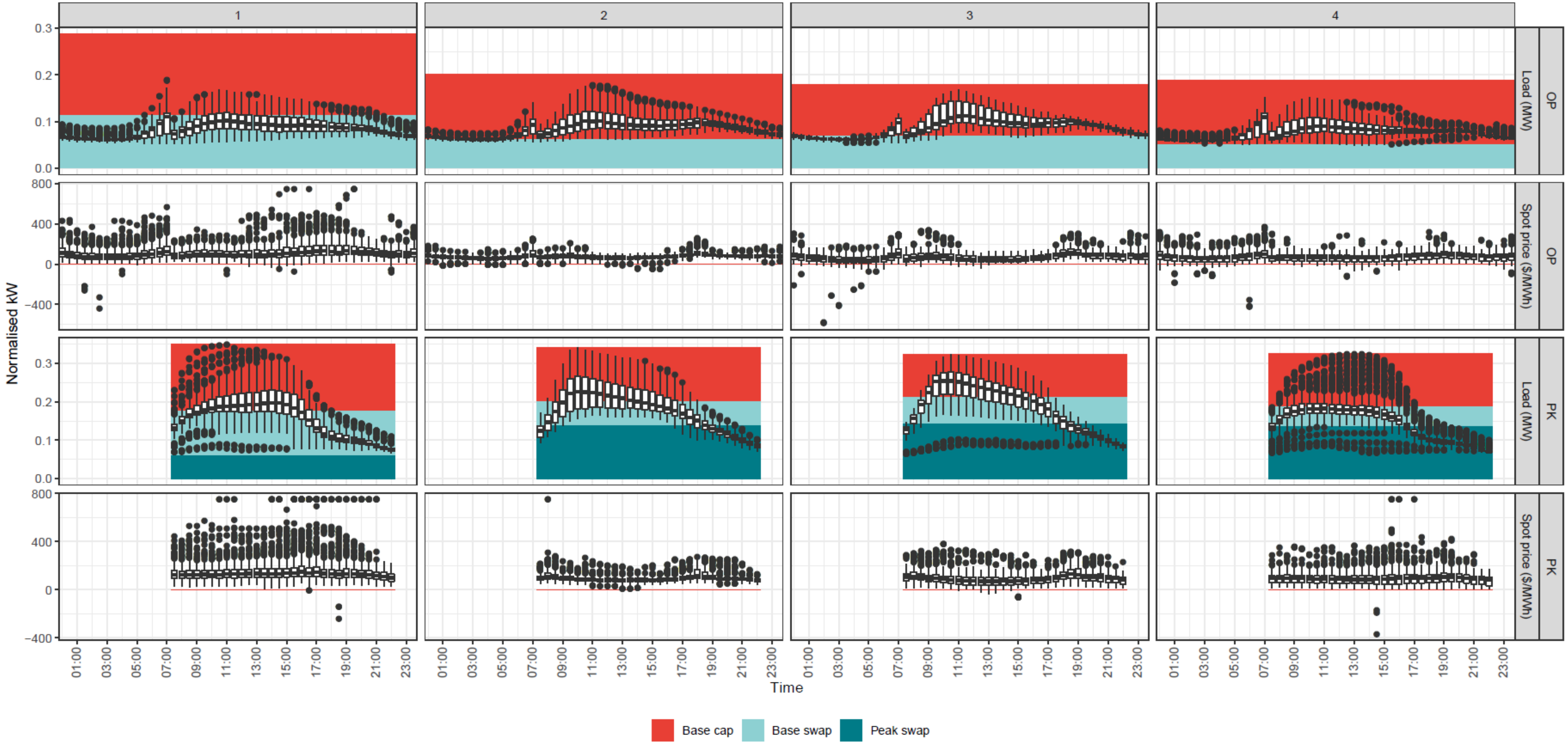
Note: Spot price chart truncated at a spot price of $750/MWh.

Figure 26: Contract position for AusNet business load, ASXEnergy contract prices, calendar year 2020 (2020 dollars)



Note: Spot price chart truncated at a spot price of $750/MWh.

Figure 27: Contract position for United business load, ASXEnergy contract prices, calendar year 2020 (2020 dollars)



Note: Spot price chart truncated at a spot price of $750/MWh.

6 WHOLESALE ELECTRICITY COSTS

Based on the data discussed in Section 3 through Section 5, this section reports the WEC that we have estimated.

6.1 Wholesale electricity costs

We estimate WEC by calculating settlement payments and differences payments resulting from the half-hourly spot prices and load, contract prices and contract position that we have developed.

Response to submissions

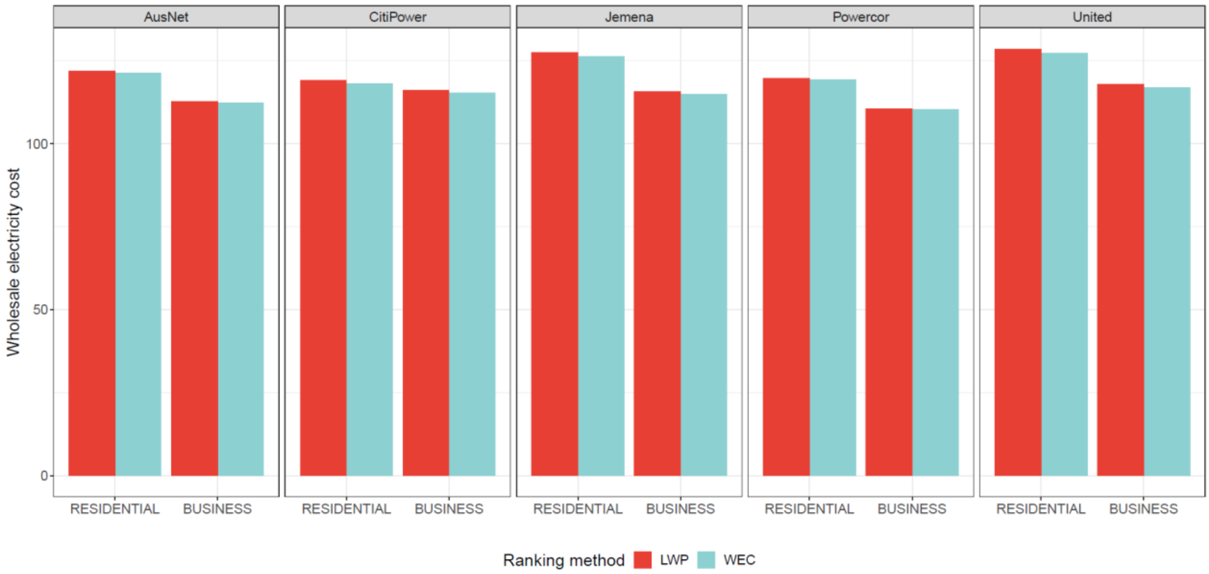
In its report for the Australian Energy Council, ACIL Allen Consulting suggested that we determine the WEC as the WEC for the median simulated year when all simulated years are ranked according to WEC, rather than the WEC for the median simulated year when all simulated years are ranked according to load weighted price. ACIL Allen Consulting apply our approach (ranked according to load weighted price) based on their own Monte Carlo simulation and conclude that the difference between these approaches would be material.

While we accept that the difference between the two approaches can be material if the results are not checked, we do check our results to ensure that our results are not subject to the issue identified by ACIL Allen Consulting. Nevertheless, we agree that this change in approach is reasonable. It is not unreasonable to think that the load weighted price may not always accurately determine the WEC, after contracting, and our own results for the 500 simulated years confirms that this is the case. We believe that taking the WEC for the median simulated year when all simulated years are ranked according to WEC is a more accurate representation of a retailer's expected costs than our current approach. While we have been careful that the WEC under our approach does not diverge from the WEC for the median simulated year when all simulated years are ranked according to WEC, we agree that it is more transparent to simply adopt ACIL Allen Consulting's recommendation.

However, we do not agree will ACIL Allen Consulting's additional recommendation that we should take the 95th percentile of the WEC. In our view, the appropriate point within the distribution of WECs to use for determining the VDO is a question for the ESC. However, we would note that choosing the 95th percentile of the WEC would lead retailers to over-recover their costs 95 years out of 100.

When updating the approach, it is not clear that choosing the WEC as the WEC for the median simulated year when all simulated years are ranked according to WEC will lead to a systematically higher or lower WEC chosen than our original approach. As a comparison, we have calculated the WEC using both methods, with the results shown in **Figure 28**. In this instance, the ranking for our updated approach results in a slightly lower WEC for all DNSPs than our original approach. This may not always be the case in future years.

Figure 28: Comparison of ranking methods on the WEC



Source: Frontier Economics

Submissions from a number of stakeholders in our advice to the ESC on the WEC for 2019/20 raised questions about the transparency of our estimate of the WEC. To address these concerns, with this final report we have released a set of spreadsheets that include all of the half-hourly price and load data, contract positions and contract prices that we use to calculate the WEC. These spreadsheets also show all of the calculations used to derive the WEC. We have released equivalent spreadsheets for our advice to the ESC on the WEC for 2019/20. The calculations in these spreadsheets make clear that the WEC accounts for the fact that a retailer cannot perfectly hedge the load of residential or small business customers using quarterly peak and off-peak contracts. Given the variability of the load of residential and small business customers there will be times when the hedge cover of a retailer is greater than the load of its customers and other times when the hedge cover of a retailer is less than the load of its customers; these outcomes are a determinant of the WEC.

In our view there are only two inputs into this spreadsheet and these calculations that are not entirely transparent:

- The Monte Carlo process used to generate the sequence of half-hourly prices and load. While we have not released the code for this Monte Carlo simulation, we do think that the process is reasonably transparent. The sequence of half-hourly prices and load that we use to calculate the WEC are simply a random sequence of days drawn from 2016/17, 2017/18 and 2018/19, with prices scaled to match the ASX forward curve, using the process we described in Section 3. We have not forecast load or prices, but merely drawn from recent history. The fact that ACIL Allen Consulting have been able to replicate our approach suggests that the approach is reasonably transparent.
- The *STRIKE* modelling used to generate the efficient contract position. While this model is proprietary, we are transparent about the resulting contract position, which is the only output from *STRIKE* that is used in estimating the WEC. We also consider that this resulting contract position is not so dissimilar to contract positions that are used by the QCA for the same purpose.

Results

The WECs that we have estimated are based on half-hourly spot prices and load from the median simulated year (when these years are ranked according to WEC). The WECs that we have estimated are based on 12-month trade weighted average ASXEnergy contract prices up to 25 October 2019. The

WECs that we have estimated are based on the contract position from the conservative point on the efficient frontier for each DNSP.

These WECs are set out in **Table 2**.

Table 2: Modelled market-based wholesale electricity cost result

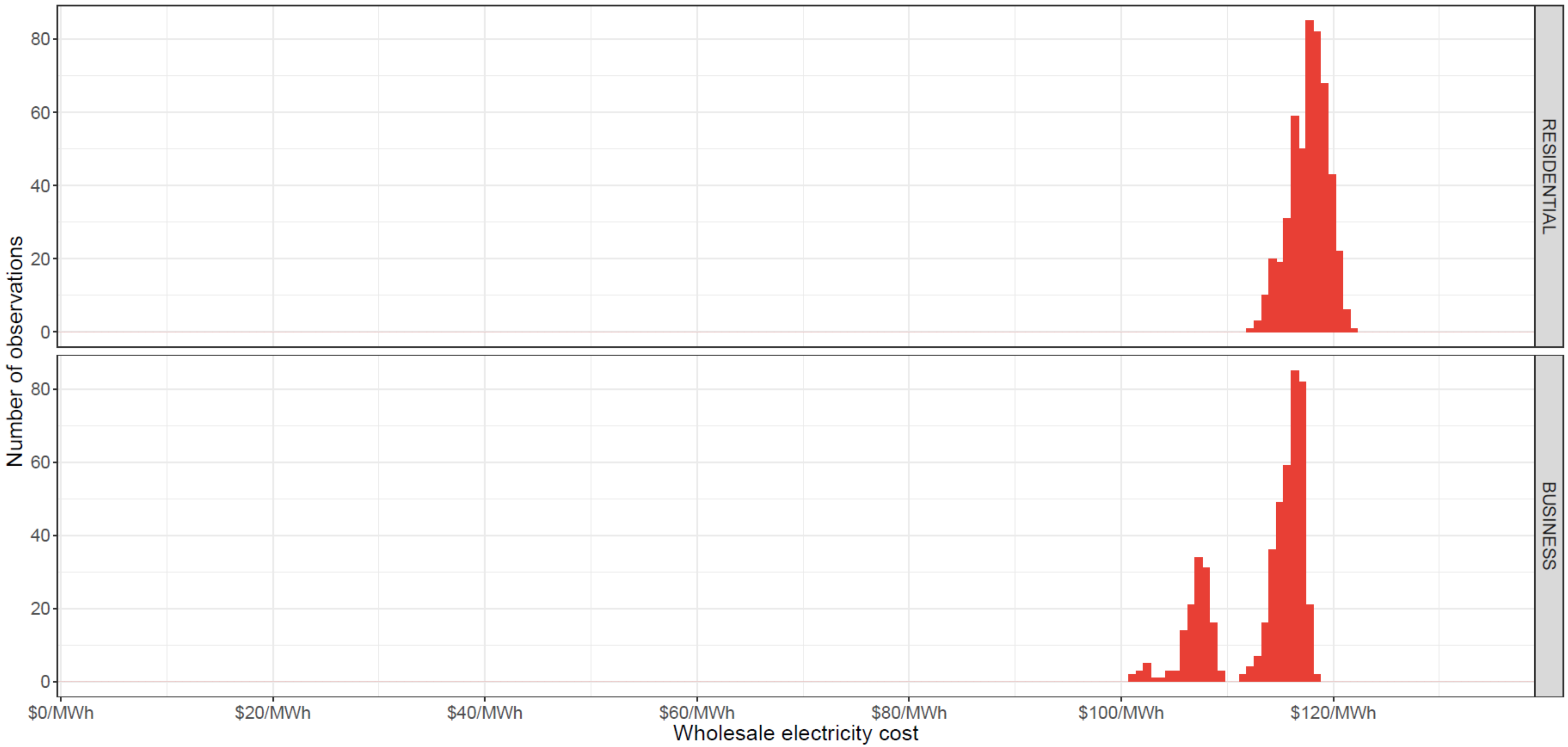
ENTITY	WHOLESALE ELECTRICITY COSTS ($/MWH, REAL $2020)	
	RESIDENTIAL	BUSINESS
AUSNET	$121.33	$112.38
CITIPOWER	$118.11	$115.32
JEMENA	$126.28	$114.85
POWERCOR	$119.20	$110.22
UNITED	$127.27	$116.94

Source: Frontier Economics

Figure 29 through **Figure 33** show the distribution of WEC for each customer type and for each DNSP area across the full set of 500 simulated years from our Monte Carlo analysis. For each of these 500 simulated years we use the same contract prices and the same contract position; all that changes between these 500 simulated years is the half-hourly profile of prices and the half-hourly load profile. Since each of these WECs is based on a hedged position, they are quite concentrated, the spread from lowest to highest usually only being $8/MWh.

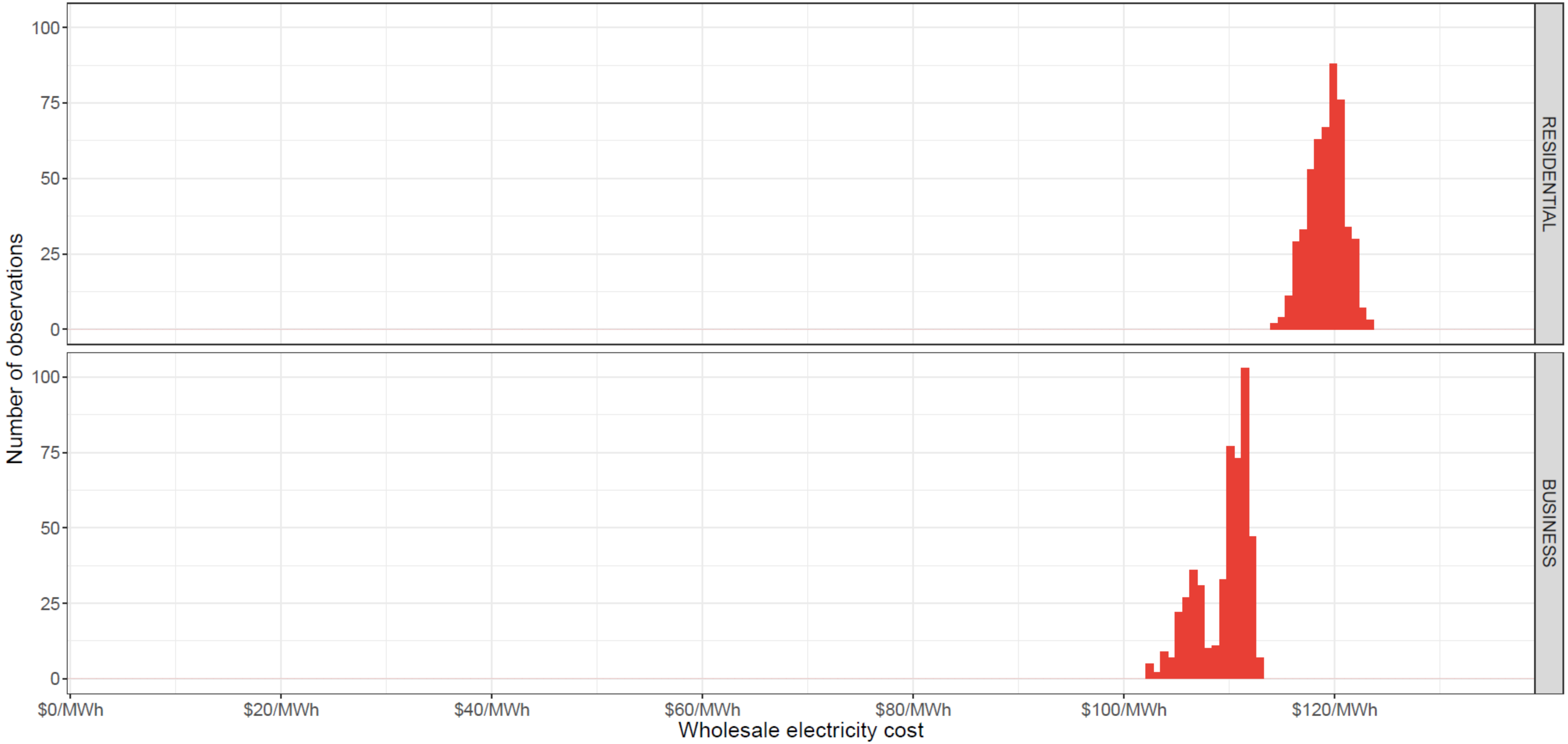
We note that these distributions do not reflect the distribution of all possible outcomes that retailers could face. If patterns of spot prices or load are materially different from the historical period on which we based our Monte Carlo analysis, or if average spot prices were too much different from suggested by current ASXEnergy contract prices, the wholesale energy cost could fall outside the range implied by these distributions.

Figure 29: CitiPower load wholesale electricity cost distribution



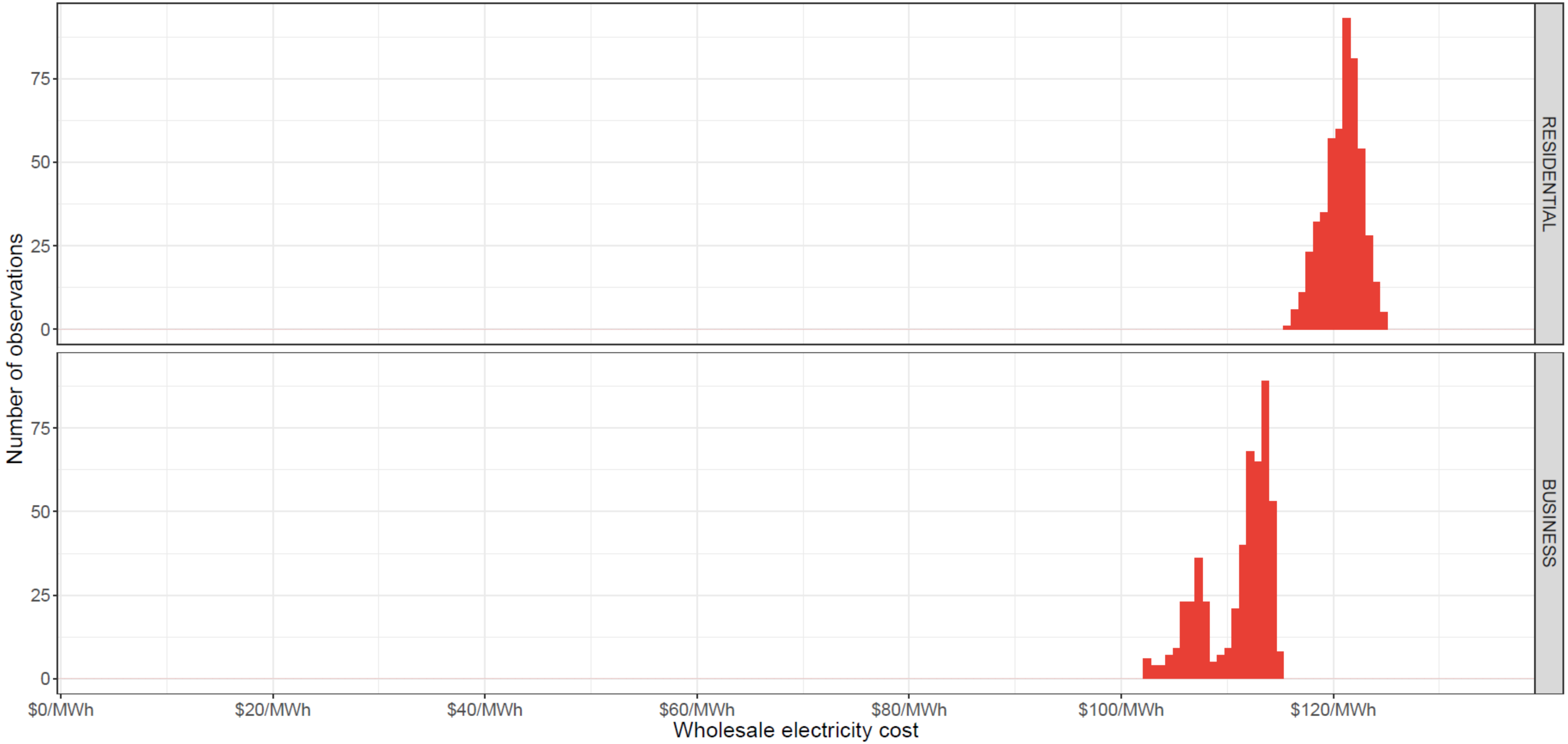
Source: Frontier Economics

Figure 30: Powercor load wholesale electricity cost distribution



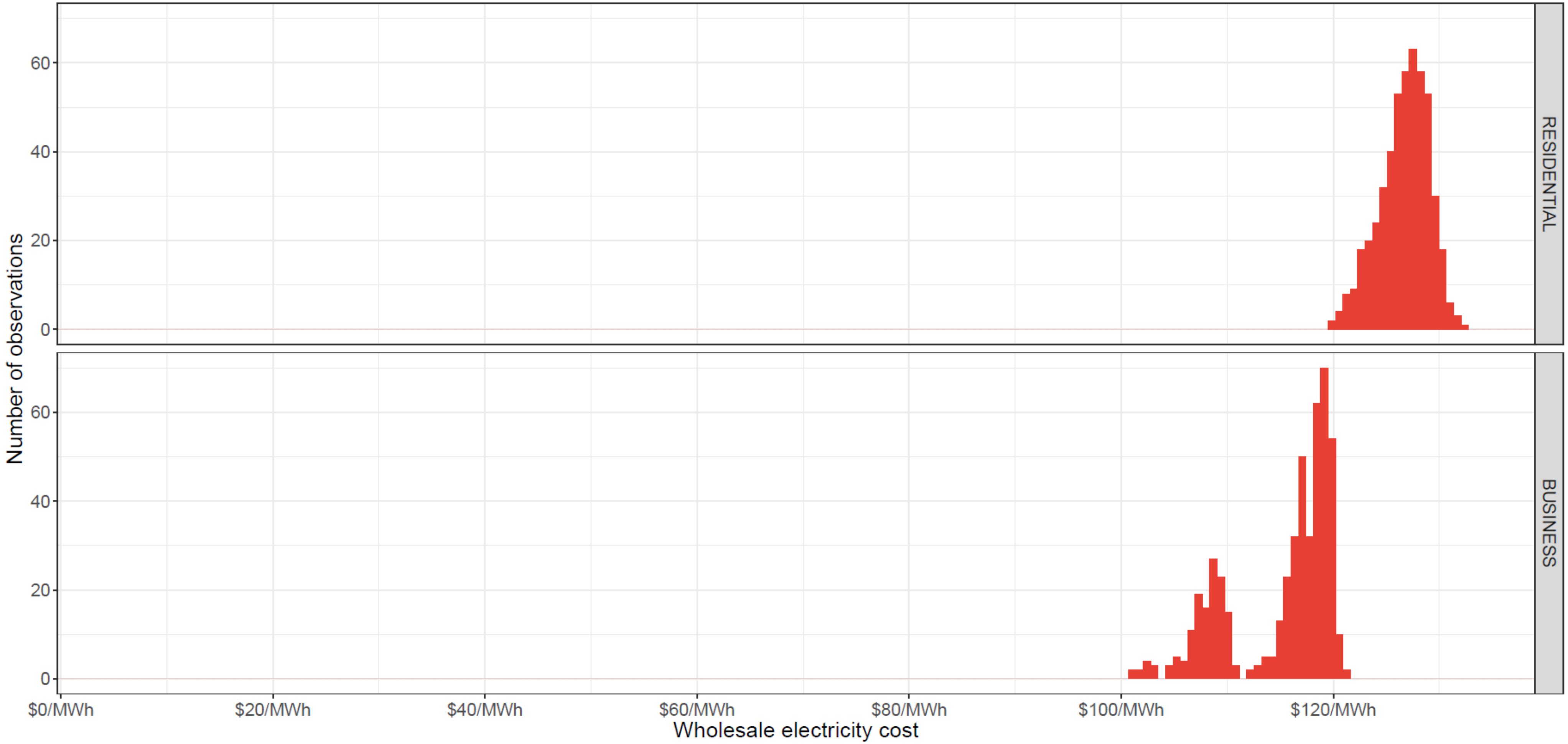
Source: Frontier Economics

Figure 31: AusNet load wholesale electricity cost distribution



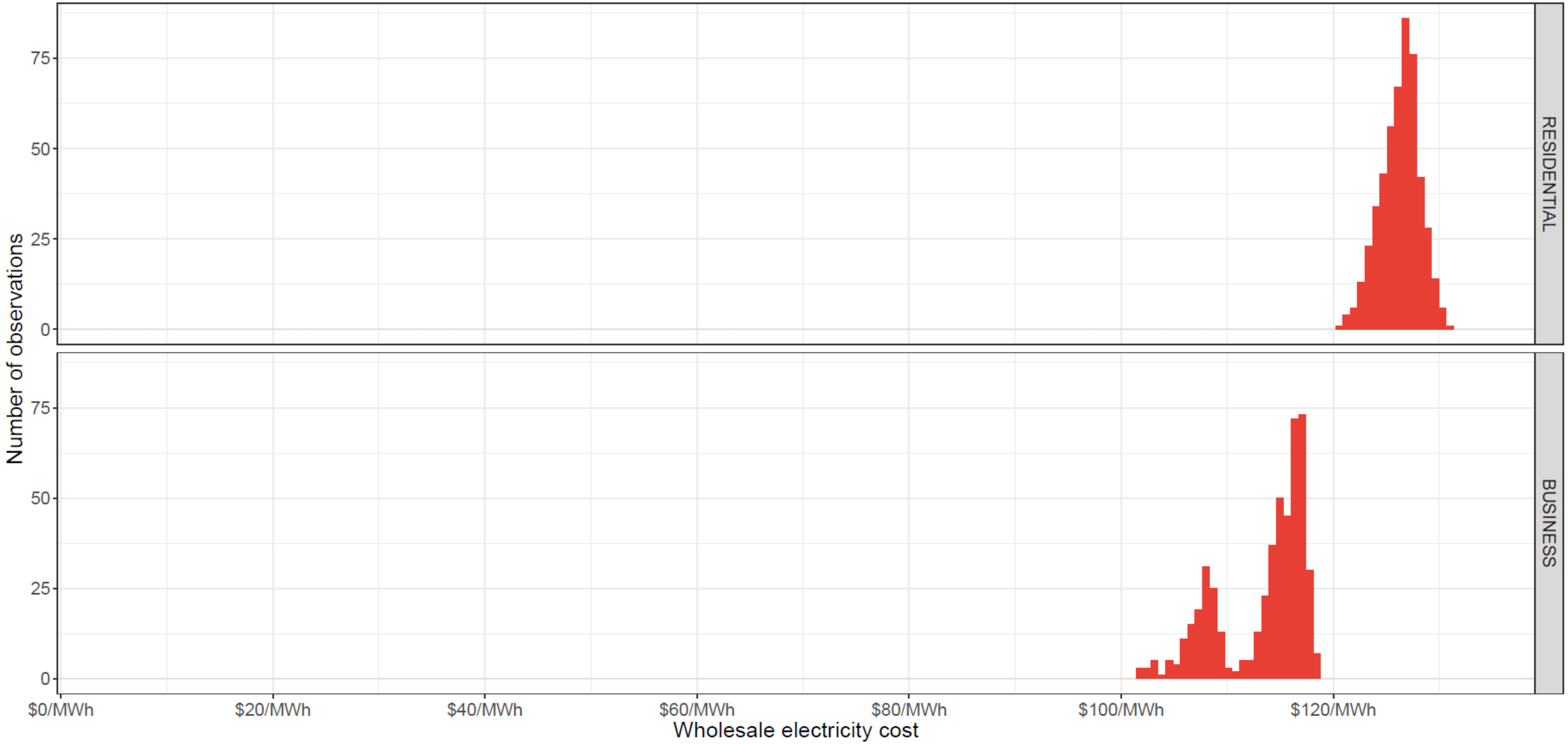
Source: Frontier Economics

Figure 32: United load wholesale electricity cost distribution



Source: Frontier Economics

Figure 33: Jemena load wholesale electricity cost distribution



Source: Frontier Economics

6.2 Volatility allowance

As discussed, the WECs that we have estimated are based on half-hourly spot prices and load from the median simulated year. The volatility allowance is intended to compensate retailers for the residual risk to which they are exposed, even when contracted at the conservative point. The volatility allowance is calculated based on the cost of holding working capital to fund cashflow shortfalls that could arise in years when the actual WEC is higher than we have estimated for the median simulated year. The working capital requirement is based on the difference between the WEC that we have estimated for the median simulated year and the WEC for the most costly simulated year for each distribution area. We then estimate the cost of holding sufficient working capital by applying a WACC of 7.5 per cent.

The volatility allowances calculated using this framework are set out in **Table 3**.

Table 3: Modelled volatility allowance

ENTITY	VOLATILITY ALLOWANCE ($/MWH REAL $2020)	
	RESIDENTIAL	BUSINESS
CITIPOWER	$0.29	$0.23
POWERCOR	$0.32	$0.19
AUSNET	$0.27	$0.19
JEMENA	$0.36	$0.28
UNITED	$0.36	$0.30

Source: Frontier Economics

7 LRET AND SRES

In addition to estimating the WEC, our scope of work also includes estimating the costs that a retailer will face as a result of the following schemes:

- the Large-Scale Renewable Energy Target (LRET)
- the Small-Scale Renewable Energy Scheme (SRES).

This section reports our estimate of these costs.

7.1 LRET

The LRET places a legal liability on wholesale purchasers of electricity to proportionately contribute towards the generation of additional renewable electricity from large-scale generators. Liable entities support additional renewable generation through the purchase of Large-scale Generation Certificates (LGCs). The number of LGCs to be purchased by liable entities each year is determined by the Renewable Power Percentage (RPP), which is set each year by the Clean Energy Regulator. LGCs are created by eligible generation from renewable energy power stations.

In order to calculate the cost to a retailer of complying with the LRET, it is necessary to determine the RPP for the retailer (which determines the number of LGCs that must be purchased) and the cost of obtaining each LGC.

Renewable Power Percentage

The RPP establishes the rate of liability under the LRET and is used by liable entities to determine how many LGCs they need to surrender to discharge their liability each year.

The RPP is set to achieve the renewable energy targets specified in the legislation. The Clean Energy Regulator is responsible for setting the RPP for each year.

The *Renewable Energy (Electricity) Act 2000* states that where the RPP for a year has not been determined it should be calculated as the RPP for the previous year multiplied by the required GWh's of renewable energy for the current year divided by the required GWh's of renewable energy for the previous year. This calculation increases the RPP in line with increases in the renewable energy target but does not decrease the RPP to account for any growth in demand. As a result, this calculation is likely to overestimate the RPP for a given year when energy demand is growing.

The Clean Energy Regulator has published a default RPP for 2019 of 18.6%. Using this 2019 RPP, and applying the default calculation, results in an RPP for 2020 of 20.15%.

Cost of obtaining LGCs

The cost to a retailer of obtaining LGCs can be determined either on the basis of the resource costs associated with creating LGCs, or on the basis of the market price at which LGCs are traded.

For this report, we have used a market price for LGCs to determine the cost of complying with the LRET. The market price for LGCs is determined by taking a 12 month trade weighted average of LGC prices reported by Demand Manager.[8] This 12 month trade weighted average LGC price is $43.30 per certificate ($2020).

Cost of complying with the LRET

Based on the RPP and the LGC price discussed above, the cost of complying with the LRET is $8.73 ($2020).

7.2 SRES

The SRES places a legal liability on wholesale purchasers of electricity to proportionately contribute towards the costs of creating small-scale technology certificates (STCs). The number of STCs to be purchased by liable entities each year is determined by the Small-scale Technology Percentage (STP), which is set each year by the Clean Energy Regulator. STCs are created by eligible small-scale installations based on the amount of renewable electricity produced or non-renewable energy displaced by the installation.

Liable entities can purchase STCs on the open market or through the STC Clearing House. These is a guaranteed price of $40/STC through the Clearing House, but certificates may take some time to clear, delaying payment to sellers of STCs.

In order to calculate the cost to a retailer of complying with the SRES, it is necessary to determine the STP for the retailers (which determines the number of STCs that must be purchased) and the cost of obtaining each STC.

Small-scale Technology Percentage

The STP establishes the rate of liability under the SRES and is used by liable entities to determine how many STCs they need to surrender to discharge their liability each year.

The STP is determined by the Clean Energy Regulator and is calculated as the percentage required in order to remove STCs from the STC Market for the current year liability. The STP is calculated in advance based on:

- the estimated number of STCs that will be created for the year
- the estimated amount of electricity that will be acquired for the year
- the estimated number of all partial exemptions expected to be claimed for the year

The STP is to be published for each compliance year by March 31 of that year. The Clean Energy Regulator must also publish a non-binding estimate of the STP for the two subsequent compliance years by March 31.

The most recent non-binding estimate of the STP for 2020 published by the Clean Energy Regulator is 14.56%.

Cost of obtaining STCs

For the purposes of this report we assume that the cost of STCs is equal to this STC Clearing House price of $40 ($2020).

8 Available at: http://www.demandmanager.com.au/. Accessed 25th October 2019

Historically, the reported spot price of STCs has typically been at, or close to, this price of $40.

Cost of complying with the SRES

Based on the STP and the STC price discussed above, the cost of complying with the SRES is $5.82 ($2020).

frontier economics

BRISBANE | MELBOURNE | SINGAPORE | SYDNEY

Frontier Economics Pty Ltd
395 Collins Street Melbourne Victoria 3000

Tel: +61 (0)3 9620 4488
www.frontier-economics.com.au

ACN: 087 553 124 ABN: 13 087 553