ESSENTIAL SERVICES COMMISSION

Victorian Default Offer 2021

Draft Decision

15 September 2020

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Contents

Our draft decision is that VDO prices should decrease

- Our draft decision on the 2021 VDO is to use generally the same approach and methodology we used in our determination on the 2020 VDO.
- Our draft decision means that on average residential bills (for those on the VDO) would fall by roughly seven per cent and small business bills will fall by roughly nine per cent from 1 January 2021.
- The decrease in bills is mainly due to a forecast fall in wholesale electricity purchase costs of 21 per cent. Wholesale costs account for 29 per cent of an annual residential bill (averaged across the five distribution zones).
- We propose that the regulatory period for the 2021 VDO is 12 months.
- Approved network tariffs for the second half of 2021 will not be available for our determination. We consider the finalisation of these tariffs by the Australian Energy Regulator (expected in late May 2021) would be a reason for us to consider varying the VDO determination during 2021.
- We have not adjusted retail cost benchmarks to reflect the impacts of the coronavirus pandemic, as we have insufficient information to justify any changes at this time.
- We note ongoing uncertainty about the impacts of the pandemic on retailers and consumers. We will continue to monitor the impacts in the lead up to our determination and into 2021. We welcome additional information from stakeholders on the impacts of the pandemic to inform our determination.
- Our draft decision is based on cost forecasts which use market data. We will update our forecasts with the most up to date data available when we make our final decision. We are also seeking feedback from stakeholders on our approach. These factors mean our final decision may vary from our draft decision.

Background

The Victorian Default Offer (VDO) was introduced by the Victorian Government on 30 May 2019 to regulate standing offer prices for electricity in Victoria. The VDO commenced on 1 July 2019.

Based on advice we prepared,[1] the Victorian Government initially set the prices retailers may charge for standing offer contracts with a flat tariff structure[2] in an Order in Council (pricing order).[3]

Standing offers are contracts that electricity retailers are obliged to make available to domestic and small business customers.[4] A standing offer will apply if the customer has:

- never signed up for an electricity contract
- entered into an electricity contract, cancelled the contract within the cooling-off period, but continues to use electricity without entering into a further contract
- moved into a new address and uses electricity without entering into a contract or
- specifically asked for a standing offer.[5]

Although prices for standing offers are regulated, electricity retailers can and do supply electricity under market offers with prices that are higher or lower than standing offers.

The pricing order also gave us the role of regulating the tariffs for all standing offers and sets out the scope and requirements we must follow when making VDO price determinations.

On 25 November 2019, we made the determination that set the VDO for calendar year 2020. This determination regulates the amounts retailers can charge customers on standing offers in Victoria. Under the pricing order, we must make a new determination for the tariffs to apply from 1 January 2021.[6] This determination must be made by 25 November 2020.

[1] Essential Services Commission, Victorian Default Offer to apply from 1 July 2019: Advice to Victorian Government, May 2019.

[2] A flat tariff does not vary by reference to the time of day, the amount of electricity used during the day, temperature or other characteristics that vary during the day.

[3] Order in Council made under section 13 of the *Electricity Industry Act 2000* and published in the Victorian Government Gazette No. S 208 on Thursday 30 May 2019. An amendment to schedule 1 was ordered in the Victorian Government Gazette, No. S 216 Tuesday 4 June 2019 (updating controlled load charges).

[4] Domestic and small business customers are customers who purchase power for personal, household or domestic use or consume no more than 40 megawatt hours in a year for business use.

[5] Sections 35, 37 and 39 of the Electricity Industry Act 2001 (Vic).

[6] Depending on the outcome of this consultation process the determination may apply for more or less than 12 months.

The VDO price determination and its objective

The objective of the VDO

The objective of the VDO is to provide a simple, trusted and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the electricity market.[7]

VDO price determination

The VDO is a set of prices that apply to all types of standing offers. The two key categories of standing offers to which the VDO applies are:

1. standing offers with tariffs that do not vary by time or usage (flat tariffs)
2. standing offers with tariffs that do vary by time or usage (non-flat tariffs).

From 1 September 2020 the VDO also applies as a maximum price for most customers in embedded networks.[8]

Customers may be able to get a better deal than the VDO

The VDO is intended to reflect a reasonably priced electricity option and provide a safeguard for customers unable or unwilling to engage in the electricity retail market. While the VDO is generally available to domestic and small business customers, only around five per cent of households and 15 per cent of small business customers are on standing offers.

For most customers, the VDO will not be the best offer available and they can access a market offer with better prices. Retailers must regularly tell customers whether they are on the retailer's best energy plan, and how much the customer could save by switching. In addition to customers on standing offers to whom the VDO applies, there are also roughly 140,000 customers in embedded networks.[9] While the vast majority may not be able to access market offers, from 1 September 2020 the VDO provides protection to most customers as a maximum price. Embedded network sellers are also free to offer prices below the maximum.

[7] Clause 3 of the pricing order sets out the objective of the VDO.

[8] Essential Services Commission 2020, Maximum prices for embedded networks and other exempt sellers: Final Decision, 22 July.

[9] ESC, Embedded electricity network data and customer numbers, available at: https://www.esc.vic.gov.au/electricity-and-gas/licences-and-exemptions/electricity-licensing-exemptions/embedded-electricity-network-data-and-customer-numbers.

Our draft decision is to keep our approach largely unchanged

At this stage, we consider that using largely the same approach as we did in our 2020 VDO price determination will best meet our legislative objectives. We have made this decision after considering all matters raised by stakeholders and all relevant provisions and matters we must have regard to under the *Essential Services Commission Act 2001 (Vic)* (ESC Act), *Electricity Industry Act 2001 (Vic)* (EI Act) and the pricing order.

Our draft decision would lead to a lower VDO

Our forecasts of the efficient costs of the sale of electricity by a retailer (efficient costs) is lower for 2021 than it was in 2020. This is mainly driven by forecast decreases in wholesale electricity costs. We also reviewed and updated the other elements of our cost stack (environmental costs, retail costs, network costs and other costs) with the most recent data available. When we make our final decision, we will update benchmarks relying on market-based information for the most recent data.

Based on our forecasts we have estimated the efficient costs for serving residential and small business customers in each of Victoria's five distribution zones. On average, across all five distribution zones, for customers on the VDO the representative residential bill will decrease by roughly seven per cent and nine per cent for the representative small business bill (see figures 1 and 2 for details).

Figure 1: The impact of our draft decision on VDO prices – estimated annual bill for residential VDO customers (average across five distribution zones)

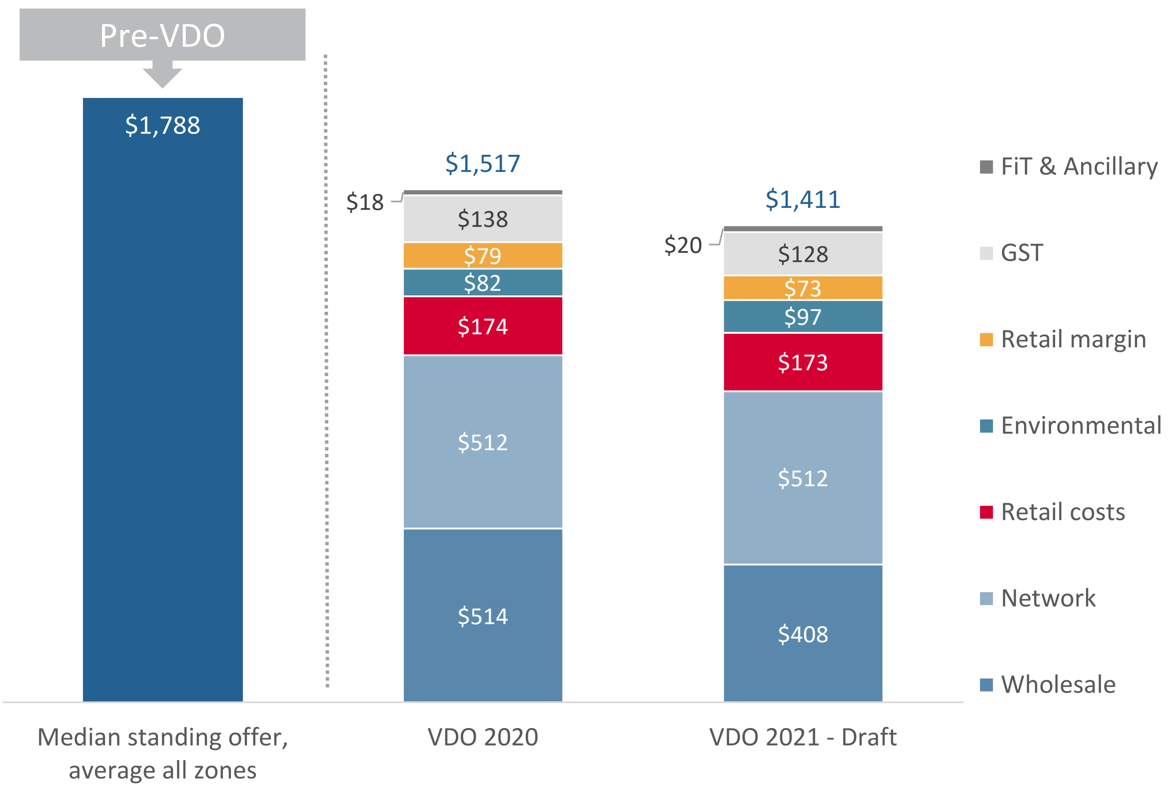
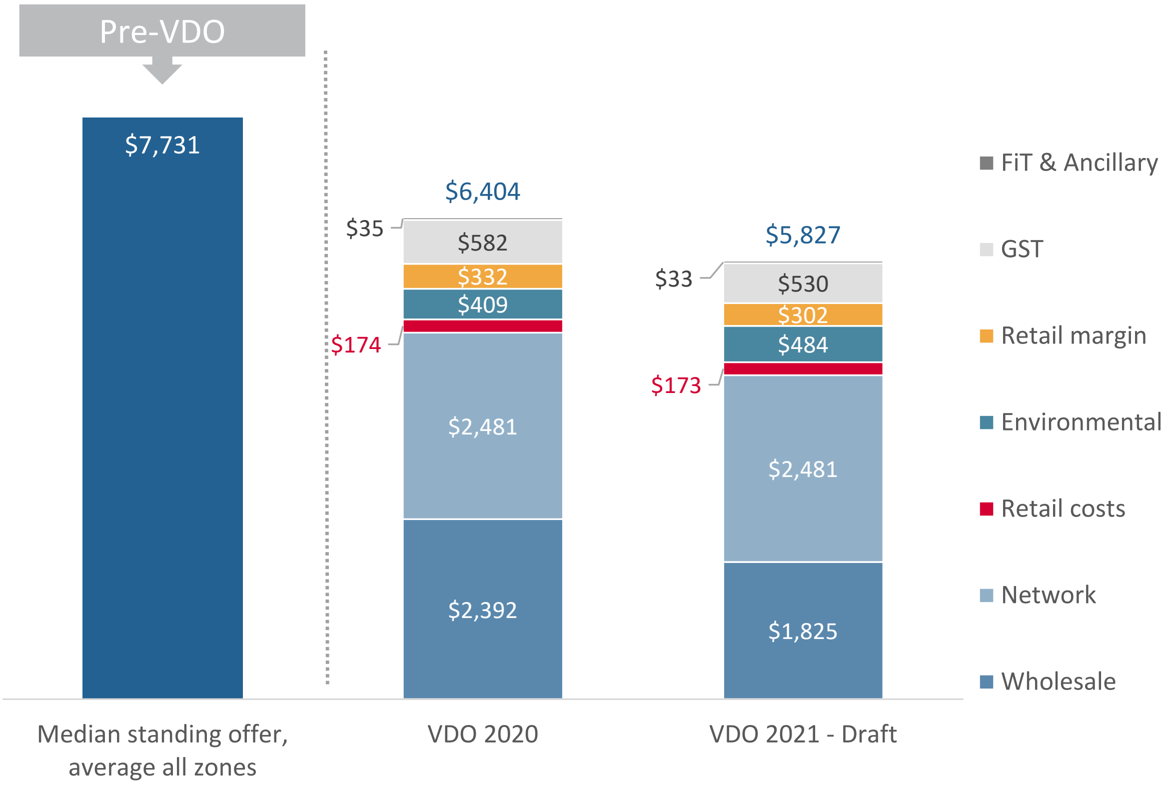


Figure 2: The impact of our draft decision on VDO prices – estimated annual bill for small business VDO customers (average across five distribution zones)



We considered the impact of the pandemic on retailer costs

As part of our review we considered the potential impact that the pandemic may have on retailers' costs. This is to help us understand the efficient cost benchmarks for the VDO.

We have not adjusted retail cost benchmarks to reflect the impacts of the pandemic, as we have insufficient information to justify any changes at this time. The cost estimates provided to us by retailers are based on assumptions about things such as future economic conditions and the extent of government stimulus. In addition, the information that is available to us, at the industry level, does not yet show that the net costs to energy retailers associated with the pandemic will be material.

Retailers did not provide us with data on total costs to serve despite us requesting this information in our consultation paper. There is also publicly available evidence that electricity retailers have made large savings in costs to serve in recent years, with further savings forecast.

This suggests there could be merit in applying an annual productivity factor to the VDO retail cost benchmarks, as we have flagged in previous reviews. We have not adopted such a factor in our draft decision, given the uncertainty associated with the effect of the pandemic on costs.

We will continue to monitor the impacts of the pandemic in the lead up to our final decision and into 2021. We welcome additional information from stakeholders, including electricity retailers, to inform how we assess and reflect considerations related to the pandemic in our determination. In particular we seek information on how retailers' costs have changed at the total level since the start of the pandemic.

The regulatory period will be 12 months, with uncertainty about network tariffs addressed through a variation process

Another uncertainty the industry faces over the 2021 calendar year relates to the level and structure of tariffs for electricity distribution networks. Electricity network costs are the largest component of our estimate of efficient costs. To most accurately reflect these costs in our cost stack we require the Australian Energy Regulator's (AER's) final decision on network tariffs.

In the past, electricity distribution networks in Victoria have had their tariffs determined by the AER on a calendar year basis. However the Victorian Government is expected to change the regulatory pricing period for electricity networks to financial years, starting in July 2021. The transition process includes a six-month extension to the current network determination period to 30 June 2021. As the VDO is currently running on a calendar year basis this will lead to a mismatch between the VDO and electricity distribution network regulatory periods.

Approved network tariffs for the first half of 2021 are scheduled by the AER to be available for our 2021 VDO determination. Approved network tariffs for the second half of 2021 will not be available for our determination. The AER expects these will be finalised by late May 2021.

Our consultation paper sought stakeholder feedback on the length of the VDO regulatory period (a six, 12, or 18-month period), noting probable changes in the regulatory period for network tariffs.

We consider a six-month regulatory period is not workable as it is likely we will not have approved network tariffs to include in any determination commencing 1 July 2021. We would need to issue a determination in late May 2021 to comply with the timing requirements in the pricing order.

An 18-month determination would require material changes to the way we estimate a number of parts of the cost stack we use to estimate efficient costs. We would require more time to consult on these changes. Also, in the context of the uncertainty relating to effect of the pandemic, an 18-month period could potentially have a greater risk of the VDO diverging from efficient costs.

We propose a 12-month regulatory period. Once the AER makes its final decision on the network tariffs applying from 1 July 2021, we would consider a variation to the VDO determination. Our approach would depend on the AER's decision and the extent of change to network tariffs. We propose to treat any change in the total revenue recovered through network tariffs as a cost pass through. Significant changes to the structure of tariffs may require further consultation.

We would consult on aligning the regulatory periods for network tariffs and the VDO at a later time.

We must complete the review in November 2020

To help stakeholders plan how they wish to engage with this review table 1 below provides indicative timelines for consultation as part of this review.

Table 1: Timeframes for the 2021 VDO review

Key milestones	Indicative date
Draft decision	15 September 2020
Draft decision – public forum	Early October 2020
Submissions on draft decision close	20 October 2020
Final decision and final determination	By 25 November 2020
2021 VDO takes effect	1 January 2021

We will continue to communicate with consumer groups, industry, and other government bodies as part of this review, but due to the pandemic we will utilise online tools where possible to replace face to face engagement activities.

We are seeking stakeholders' views

In this paper we set out our draft decision on our approach and methodology for the 2021 VDO determination.

We are interested in any feedback stakeholders have on our approach to setting the VDO for this next regulatory period. In particular we seek feedback from stakeholders on:

- the impact of the pandemic on retailers' costs at the total level
- how to account for the effect of the pandemic
- how to account for the uncertainty around network tariffs and
- the regulatory period.

How to provide feedback

Both general comments and formal submissions should be made by **5pm 20 October 2020**. We may place lower weight on, or may not be able to consider, submissions received after this deadline.

To make a submission on this paper please go to Engage Victoria's website: www.engage.vic.gov.au.

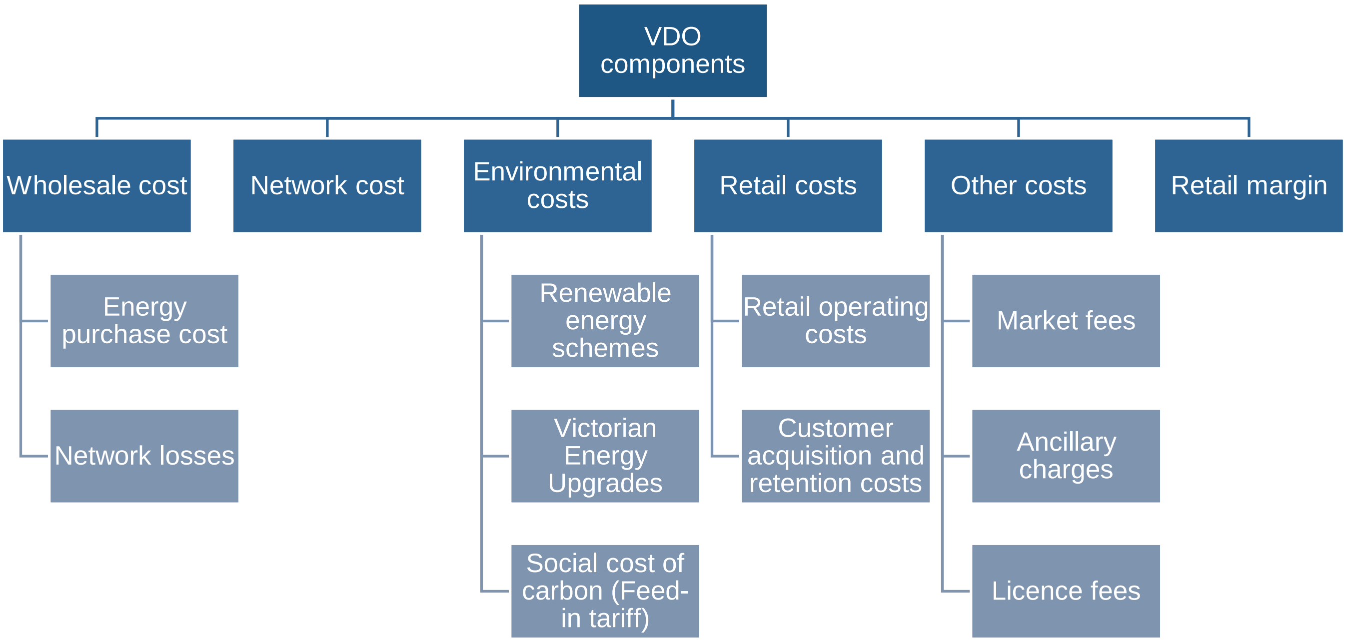
If this presents an issue please email us at VDO@esc.vic.gov.au or call Jonathan Roberts on 03 9032 1307 to discuss other options for making a submission.

All submissions come under our submissions policy. Submissions will be made available on our website, except for any information that is commercially sensitive or confidential. Submissions should clearly identify which information is sensitive or confidential. Anonymous submissions will generally not be accepted.

VDO cost components

To set the Victorian Default Offer (VDO) tariffs, we must first estimate the efficient costs of providing retail electricity services to be recovered through those tariffs. Figure 3 sets out the key items we propose to include in our estimate of efficient costs.[10]

Figure 3: Cost items included in the VDO cost stack



A summary of our approaches to estimating each item that makes up the total VDO costs is as follows:

- **Wholesale electricity costs** – based on the expected future electricity costs in the market, which also includes the cost of electricity lost when it is transported
- **Network costs** – taken directly from the tariffs approved by the Australian Energy Regulator
- **Environmental costs** – using available market data on the expected future costs of meeting renewable energy schemes and the Victorian Energy Upgrades program
- **Retail costs** – based on benchmarks from previous regulatory decisions
- **Other costs** – taken directly from published reports from industry bodies
- **Retail operating margin** – based on a benchmark from a comparable regulatory decision.

[10] Clause 12(4) of the pricing order that requires the commission to account for a particular set of costs.

As part of this review we updated the estimates included in the VDO cost stack to reflect changes in the market and new data that is now available. When we make our final decision we will update our estimates again with the most recent data available.

In preparing this draft decision we undertook further analysis of our already established approach to the VDO and the current economic environment. We also considered the impact of the coronavirus pandemic (the pandemic) on electricity consumption and retailers' costs.

Wholesale electricity costs

- Our draft decision is to use forecasts of wholesale electricity prices based on futures prices from ASX Energy. This is consistent with the approach we used in making our 2020 VDO price determination.
- Wholesale electricity purchase costs make up around 29 per cent of an annual residential bill (averaged across the five distribution zones).
- We estimate that wholesale electricity costs included in our 2021 cost stack for residential users will decrease by around 21 per cent when compared to the benchmark included in our 2020 determination.

We forecast energy purchase costs will decline

Energy purchase costs are incurred by retailers when they purchase electricity from the wholesale market to meet the demand of their customers. The pricing order requires us to have regard to the efficient costs of providing retail electricity services, including wholesale electricity purchase costs.[11] We have used a futures market approach to estimate a benchmark energy purchase cost allowance for 2021. We used this approach in making our determination on the 2020 VDO. This approach is also consistent with the approach taken by other Australian regulators.[12] Our draft decision forecast is lower than the allowance provided in 2020.

Energy purchase costs

Electricity generators supply wholesale electricity to the National Electricity Market which matches generation with demand in real time. Electricity retailers must secure a supply of wholesale electricity, and while some retailers own generators, many buy electricity directly from generators on the spot market. Buying electricity from the spot market exposes retailers to the risk that

[11] Clauses 12(3) and 12(4) of the order.

[12] Other regulators including the Queensland Competition Authority, the Independent Competition and Regulatory Commission (in the ACT) and the Australian Energy Regulator have used a futures approach to forecast wholesale electricity costs.

electricity prices may be high when they need to purchase electricity. An efficient approach to managing this risk is the use of hedging. If a retailer hedges its wholesale electricity risk, the price they pay for electricity is set in advance or capped. Retailers can hedge by either contracting directly with a generator, or through a financial market – the futures market on ASX Energy.

We engaged Frontier Economics to estimate wholesale electricity purchase costs

We engaged Frontier Economics to estimate wholesale electricity purchase costs. We accept Frontier Economics' recommendations as reflecting a benchmark of efficient wholesale electricity purchase costs for the purpose of estimating the VDO. A full description of Frontier Economics' methodology, including data sources, is included in its report.[13] A summary is provided below.

Frontier Economics determined the relationship between load and spot prices, using four years of historical data 2016-17, 2017-18, 2018-19 and 2019-20. Half-hourly customer load data was provided directly by the Australian Energy Market Operator (AEMO).[14] Victorian half-hourly spot prices for the same period were sourced from AEMO's publicly available data.

Frontier Economics performed a Monte Carlo simulation using historical data on load and price. The simulation randomly generates a year of half-hourly observations. This process is repeated 500 times to generate a range of simulated years.[15] Each simulated year is normalised in order to maintain load shape and the correlation between load and price. Each simulation is then scaled to half-hourly prices so that the time-weighted average prices in each quarter equal the relevant quarterly ASX Energy base swap price for 2021, subtracting a contract premium.[16]

It then estimated the cost of hedging, as well as the hedging position a prudent retailer would likely adopt. To estimate the cost of financial hedging, 12-month trade-weighted hedging contract prices on quarterly electricity derivative contracts were used; base and peak swaps, and base $300 caps. An efficient contracting position was then estimated using Frontier Economics' STRIKE model. An allowance for holding working capital (cash) to fund spot market purchases was also included – a volatility allowance which funds shortfalls during periods of very high spot prices.

From 1 July 2021, base $300 cap contracts (which can be purchased up to four years in advance) have been delisted from ASX Energy. This is due to AEMO's rule change to five-minute

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[13] Frontier Economics, Wholesale electricity costs for 2021: a draft report for the Essential Services Commission, 27 August 2020.

[14] AEMO directly provides us with separate half-hourly load data for each of Victoria's five distribution zones, for both residential and small business customers with an annual consumption less than 40MWh.

[15] The random drawing of data is done from a pool of like days, where days are classified as either weekdays or weekends, from either Q1 (January to March), Q2 (April to June), Q3 (July to September) and Q4 (October to December).

[16] The assumed contract premium is five per cent on the underlying prices.

settlements in the National Electricity Market.[17] [18] Frontier Economics has assumed a price for $300 caps in the second half of 2021 based on the relationship between quarter 1 caps and quarter 3 and 4 caps in 2020, and the price of quarter 1 caps in 2021.[19]

We considered the potential for changes in wholesale costs due to the coronavirus pandemic

We have considered the effect the pandemic may have had on patterns of electricity consumption in Victoria. Frontier Economics examined existing data from 2020 and compared it with data from previous years, and found since April 2020:

- average weekday consumption has fallen for small business customers, and
- average weekday consumption has risen for residential customers.

On the typical daily pattern of consumption (load shape), Frontier Economics found some evidence of variability, but this variability is consistent with prior years and is not indicative of any widespread or consistent change in daily patterns of consumption.[20]

We will continue to monitor trends in the wholesale market and update our estimate ahead of making a final decision.

We factored network losses into our decision

When electricity is transported through transmission and distribution networks, some of it is lost in the process. Electrical losses occur because of electrical resistance in the wires, converting some electricity to heat. These losses must be factored into any electricity purchased through the wholesale market to ensure supply meets demand. As a result, more electricity is generated than is consumed by end users.

Our draft decision uses the latest data from the AEMO for:

- Distribution loss factors – the short sub-transmission factor for each distribution zone.[21]

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[17] On 22 January 2018, ASXEnergy announced the temporary withdrawal of Australian Electricity Base Load Calendar Quarter $300 Cap futures for the Q3 and Q4 2021. More information is available in ASXEnergy's bulletin https://www.asxenergy.com.au/newsroom/industry_news/delisting-of-australian-elect.

[18] In November 2017, the Australian Energy Market Commission ruled to change the settlement period for the electricity spot price from 30 minutes to five minutes – commencing 1 October 2021. This was done on the basis that five-minute settlements provide a better price signal for investment in fast response technologies, such as batteries, new generation gas peaking power plants and demand response (which incentivises businesses to reduce demand during peak events).

[19] Frontier Economics, Wholesale electricity costs for 2021: a draft report for the Essential Services Commission, 27 August 2020, p. 24.

[20] Frontier Economics, Wholesale electricity costs for 2021: a draft report for the Essential Services Commission, 27 August 2020, p. 9.

[21] Australian Energy Market Operator, Distribution Loss Factors for the 2020-21 Financial Year, August 2020, p. 13.

- Marginal loss factors – the relevant regional reference node factor for each distribution zone.[22]

We combine these to calculate an adjustment factor which is applied to energy purchase costs, environmental costs and ancillary charges.

We considered matters raised by stakeholders

In response to our consultation paper, some stakeholders stated that they support our general approach to wholesale electricity costs.[23] However, we also received several submissions seeking changes to our approach. Some of the issues raised were considered in previous reviews. We did not receive any strong new evidence that suggested we should change our approach.

Consumer Action Law Centre recommended wholesale market risk and the cost of managing it should be borne by retailers (not individual or household energy users), noting unexpected events such as the pandemic should not by themselves lead to a presumption of increasing the wholesale (or other) allowances for the VDO.[24] We agree to the extent that our benchmarks established for the VDO should reflect an estimate of the efficient costs to deliver an electricity retail service.

Consumer Action Law Centre also suggested that we should seek to incorporate the full range of risk-management strategies available to retailers in managing their wholesale costs, and not promote a particular market structure – rather base benchmarks on fair and lowest cost energy for households.[25]

As noted above, we have used a futures market approach, which reflects the market's current view about the level of wholesale prices in the regulatory period. Our approach is based on transparent market-based data, and we note that information on over the counter contracts, power purchase agreements and vertical integration is not readily available nor is it transparent. Our estimate reflects an efficient wholesale purchase cost, faced by a retailer of any size or structure.[26]

Alinta Energy, the Australian Energy Council, GloBird Energy and Origin Energy told us they did not support setting wholesale electricity costs based on the median (50th percentile) of simulated years, which is the approach adopted by Frontier Economics. They suggested the appropriate

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22 Australian Energy Market Operator, Regional and Marginal Loss Factors: FY 2020-21, July 2020, p. 20.

23 AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4.

24 Consumer Action Law Centre, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3-4.

25 Consumer Action Law Centre, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4-5.

26 Section 12(3) of the order requires that the tariffs determined by the commission are to be based on the efficient costs of the sale of electricity, with section 12(8) noting that we are not required to determine tariffs based on the actual costs of a retailer.

point within the distribution of simulated wholesale costs is the 95th percentile.[27] This matter was raised in determining 2020 VDO prices. We maintain the view that taking the median approach better fits the requirements of our pricing order, that is to base our determination on efficient costs that do not provide for headroom.[28]

Powershop and MEA group, and Globird Energy requested we review our previous wholesale electricity cost allowance against historical outcomes.[29] We note that our methodology for calculating a wholesale electricity purchase cost benchmark is intended to derive a forecast of efficient costs. The pricing order requires us to determine the efficient costs of the sale of electricity. We are not required to determine tariffs based on the actual costs of a retailer.

EnergyAustralia raised the issue of our approach to calculating loss factors.[30] It is our view that basing distribution loss factors on the short sub-transmission factor for each distribution zone as published by the AEMO is transparent and reflects losses for most VDO customers.

Network costs

- Our draft decision is to continue to use a cost pass-through approach towards estimating network costs.
- For our draft decision on these network costs, we have used the tariffs approved by the AER for the 2020 calendar year, as approved 2021 tariffs are not yet available. This means the dollar amount in the average bill will remain the same.
- Network costs represent about 36 per cent of costs in the average residential bill (averaged across the five distribution zones).

[27] Alinta Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 1. The Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2. GloBird Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2. Origin Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2.

[28] Clause 12(3) and 12(10) of the order.

[29] Powershop and MEA Group, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3. GloBird Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 6.

[30] EnergyAustralia, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 9.

Network costs represent the costs of building, operating and expanding the electricity distribution and transmission networks. We are required to have regard to network costs in estimating efficient costs.[31]

There are five electricity distribution networks operating in five separate zones across Victoria, each with their own specific requirements in terms of maintenance and expansion. The charges levied by each network are approved by the AER on an annual basis.

For all domestic and small business electricity customers, there are three main elements associated with each network tariff:

- Distribution charges – tariffs for the use of the distribution network.
- Transmission charges – tariffs for the use of the transmission network.
- Jurisdictional charges for the payments distributors are required to make.

Our draft decision is to maintain our approach to network tariffs

We propose to retain our approach from the 2020 VDO for calculating network costs. This is a cost pass through approach using the simplest network tariff approved by the AER for each distribution zone (see Appendix A). This is generally made up of a daily supply charge and a flat usage charge. We also include metering charges for each distribution zone, and a controlled load option for domestic customers. For our draft decision on these network costs, we have used the tariffs approved by the AER for the 2020 calendar year, as approved 2021 tariffs are not yet available.

The Victorian Government plans to move Victorian distribution networks' regulatory period to financial years from calendar years. To accommodate this, the current regulatory period for networks is expected to be extended by six months, to 30 June 2021. Approved network tariffs for the first six months of 2021 are expected to be available for our final decision. However, approved network tariffs for the second half of 2021 will not be available. We discuss our proposed approach to addressing this mismatch through a variation process, in the chapter on other considerations.

We considered stakeholders' submissions on network charges

AGL, Origin Energy, Simply Energy and the Australian Energy Council supported our established approach to estimating network costs.[32] However, we received submissions from stakeholders raising a number of matters that we have previously considered as part of prior VDO price reviews.

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[31] Clauses 12(3) and 12(4) of the order.

[32] AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4; Simply Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; Origin Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; The Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2-3.

Accounting for metering costs

EnergyAustralia submitted that our current approach to estimating metering costs understates the efficient costs of servicing customers and supported an alternate methodology based on the average cost of metering configurations, or as previously proposed for the 2020 VDO, a customer-weighted average of the costs of different meter types.[33]

Our draft decision is to retain our approach from the 2020 VDO to estimating metering costs. We will use the simplest AER approved Advanced Metering Infrastructure charges for single phase meters in each distribution zone as a cost per customer.

We have previously addressed EnergyAustralia's proposals for a customer-weighted average approach.[34] We consider using a weighted average will most likely overestimate metering costs for VDO customers. We have also not received new or compelling evidence from retailers since we last considered this matter, to consider changing our approach.

Accounting for non-flat tariffs

Some stakeholders repeated concerns about differences between the flat tariffs we have used in our approach to estimating network costs and the underlying costs for customers on non-flat tariffs.[35] Some proposed that a simple solution would be to allow retailers to either obligate Victorian network businesses to change a customer's non-flat network tariff to a flat tariff or allow retailers to assign customers to flat network tariff structures where they choose the VDO. We note both approaches require a change to the regulatory framework which is outside the scope of our VDO price determination.

Environmental costs

- Our draft decision is to continue to use the approach to estimating environmental costs that we proposed in our final decision on the 2020 VDO.
- Environmental costs represent about seven per cent of the average residential bill (averaged across the five distribution zones).

[33] EnergyAustralia, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 9-10.

[34] Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Final Decision, November 2019, p. 33.

[35] Tango Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; Powershop and MEA Group, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4; The Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2-3.

- Our draft decision means the dollar value of environmental costs in the cost stack would increase. This is mainly driven by increases in costs associated with the federal small-scale renewable energy scheme and Victorian Energy Upgrades.

Under the pricing order, we are required to have regard to environmental costs.[36] There are four main environmental costs faced by Victorian electricity retailers:

- Large-scale Renewable Energy Target
- Small-scale Renewable Energy Scheme
- Victorian Energy Upgrades and
- The social cost of carbon applied to the minimum feed-in tariff.

Our draft decision is to maintain our approach to calculating environmental costs

Our draft decision on how we calculate these components of the VDO are as follows:

- Small-scale Renewable Energy Scheme (SRES) – the mid-point of the 2021 non-binding small-scale technology percentage (STP) and 2020 binding STP will be multiplied by the clearing house price, plus an allowance to account for the difference in the level of the STP we used in the 2020 VDO and the actual binding STP for 2020.
- Large-scale Renewable Energy Target (LRET) – the 2021 default renewable power percentage will be multiplied by the futures market price for large-scale certificates.
- Victorian Energy Upgrades – the 2020 greenhouse reduction rate for electricity will be multiplied by the historic 12-month average price for Victorian Energy Efficiency Certificates. The 2021 reduction rate will be available for us to use in our final decision.
- The above costs will be multiplied by network loss factors.
- Minimum feed-in tariff (social costs of carbon) – total renewable exports in 2019-20 will be divided by average total domestic and small business customers in 2018-19, multiplied by the social cost of carbon (2.5 cents). When we make our final decision, the total customers for 2019-20 will be available and we will update our estimate accordingly.

Our draft decision allowance for environmental costs is higher than the allowance included in the 2020 VDO. In the average annual bill for residential and small business customers, the allowance for environmental costs has increased by around 18 per cent. This is largely because of changes to the level of some inputs used to calculate the SRES and VEU components of environmental costs.

An increase in the forecast level of the STP has increased the level of SRES costs. This is in part due to the federal Clean Energy Regulator setting a higher non-binding STP for 2021 as a result of

[36] Clauses 12(3) and 12(4) of the order.

higher than expected roof-top solar uptake.[37] Another driver of the increase is that, as set out in our last review, we have included an allowance for the gap between the forecast STP we used in the 2020 VDO and the actual binding STP for 2020. The calculation of this component is discussed in more detail in appendix B.

An increase in the price of Victorian Energy Efficiency Certificates has increased the allowance for VEU costs. This is based on the historic 12-month average price of these certificates.

We have retained our approach to calculating the SRES allowance

Our draft decision is to maintain our approach to calculating the cost of the SRES. We use the mid-point of the 2021 non-binding STP and the 2020 binding STP, multiplied by the clearing house price. We have also, as foreshadowed in our last review, included an allowance to account for the discrepancy between the level of the forecast STP we used in the 2020 VDO and the actual binding STP for 2020.

Some submissions suggested we adopt alternative approaches.

Amaysim submitted that the current methodology to forecast the STP should be revisited, proposing the higher value between the non-binding and binding STP be used in calculating the allowance for complying with the SRES.[38] AGL submitted that a better estimate of the STP is required, proposing a method to forecast the STP using Small-scale Technology Certificate creation and exemptions.[39]

GloBird Energy proposed the cost difference between the binding STP and commission estimate of the 2020 STP be added to the 2021 VDO, along with a small buffer to address the risk of the 2021 binding STP being higher than our estimate.[40] The Australian Energy Council proposed we should include an adjustment in the VDO to account for the fact the actual binding STP for 2021 will not be released in time to include in our draft or final decision.[41]

[37] Clean Energy Regulator, Quarterly Carbon Market Report – June quarter 2020, p. 28.

[38] amaysim, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4.

[39] AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2.

[40] GloBird Energy submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 6-7.

[41] The Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3.

Origin Energy, Simply Energy, Red Energy and Lumo Energy submitted that our approach used for the 2020 was pragmatic under the circumstances.[42]

After considering the approaches proposed by stakeholders, we have retained our approach to estimating the level of the STP for the 2021 VDO, plus an allowance to account for the difference between the value of the forecast STP in the 2020 VDO and the binding STP for 2020. We consider this approach is simple, and transparent, compared to the alternatives proposed.

Further, we have not included a buffer to account for future variances in SRES costs as the VDO is designed to reflect the efficient costs of the sale of electricity.[43] We consider that including a buffer to account for potential variances in the SRES is not an efficient cost, and inconsistent with the requirements of the pricing order not to include headroom in the VDO.

We have retained our approach to calculating the LRET allowance

We have retained our approach to calculating the cost of complying with the large-scale renewable energy target (LRET). Our approach will use the 2021 default renewable power percentage multiplied by the futures market price for large-scale certificates, to estimate the cost to retailers of complying with the LRET.

As the futures market price of large-scale generation certificates is publicly available market information, we consider our approach offers a transparent and reliable method for estimating the efficient cost of the LRET for retailers.

Several submissions we received on our consultation paper raised that the market price of Large-scale Generation Certificates (LGCs) is not reflective of retailers' underlying cost of complying with LRET obligations.[44] Some retailers supported adopting alternate methodologies to account for the resource cost of procuring LGCs. AGL and Alinta Energy suggested an approach based on

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[42] Origin Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; Red and Lumo Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4; Simply Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2.

[43] Section 12(3) of the order sets out the tariffs determined by the Commission pursuant to the VDO price determination are to be based on the efficient costs of the sale of electricity by a retailer.

[44] AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 5; Alinta Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 1; The Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3; GloBird Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 6; Origin Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2 and EnergyAustralia, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 10.

historical Power Purchase Agreement (PPA) prices and LGC formation.[45] EnergyAustralia and the Australian Energy Council proposed an approach using data on PPAs and market share to create a weighted average.[46] GloBird Energy supported a true-up, plus a small allowance to account for the difference between the forecast and actual renewable power percentage in the 2020 VDO.[47]

We do not consider that PPA prices are a suitable input to estimate the costs of complying with the LRET as they are often bespoke agreements tailored to the needs of the retailer entering the arrangement. Additionally, PPAs bundle LRET costs with the cost of purchasing wholesale electricity, this would mean using PPAs as an input to estimate LRET costs would create inconsistency with our approach for estimating wholesale electricity costs.

To test retailers' claims that our current approach under-compensates them, we compared the sum of LGC and wholesale costs in retailers' actual costs and our VDO allowances. Our analysis of data provided by retailers shows that the combined allowances are comfortably within the range of retailer's actual costs.[48]

While some retailers will have costs higher than the amount in our allowance for LGCs and wholesale electricity, it would not be reasonable to set a VDO allowance above the costs of the least efficient retailer. We consider that our approach will allow retailers to recover the efficient costs associated with complying with the LRET scheme.

We have retained our approach to calculating Victorian Energy Upgrades costs

Our draft decision is to calculate the cost of the Victorian Energy Upgrades (VEU) scheme using the 2020 greenhouse reduction rate for electricity, multiplied by the historic 12-month average price for Victorian Energy Efficiency Certificates. We expect the 2021 reduction rate to be available for our final decision.

We have considered submissions from stakeholders on VEU costs. Simply Energy submitted our approach to setting an allowance for VEU costs is reasonable.[49] The Australian Energy Council

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[45] AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 5; Alinta Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 1.

[46] EnergyAustralia, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 14; Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3.

[47] Globird Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 9-10.

[48] The most recent validated data we have available is for financial year 2018. We are in the process of validating the financial year 2019 cost data with retailers. This process has taken longer than expected due to the large volume of queries required during the validation process and a number of late responses.

[49] Simply Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2.

submitted they expect the costs of complying with the VEU scheme will increase in 2021 in response to possible increases in the number of certificates retailers will have to generate and the potential restriction of some certificate generating activities. It proposed an allowance to be included in the 2021 VDO to account for a mid-year increase in retailers' VEU costs.[50]

In the absence of further information, we have maintained our approach, noting the price of Victorian Energy Efficiency Certificates we use to estimate the allowance for VEU costs has increased.

We have retained our approach to calculating the cost of the minimum feed-in tariff

Our draft decision is to maintain our approach to calculating the cost of the minimum feed-in tariff. To estimate an allowance, we will use the total renewable exports in 2019-20 divided by average total domestic and small business customers in 2018-19, multiplied by the social cost of carbon (2.5 cents).

We considered stakeholders submissions on the minimum feed-in tariff. Simply Energy submitted our approach to setting an allowance for the minimum feed-in tariff is reasonable.[51] GloBird Energy submitted that their costs of complying with the minimum feed-in tariff are higher than the allowance we made in the 2020 VDO, proposing we should include the difference between their actual costs and the allowance in the 2021 VDO, along with a small buffer.[52]

We consider that our approach to setting an allowance for costs associated with the minimum feed-in tariff is appropriate. The VDO allowance is not designed to allow all firms to recover their actuals costs, rather it is an allowance to allow the recovery of efficient costs. Additionally, including a buffer amount would result in including headroom in the VDO cost stack which is not allowable under the pricing order.

Retail operating costs

- Our approach is to continue to use a benchmarking approach to set retail operating costs. This is consistent with the approach we used in our final decision on the 2020 VDO.
- Retail operating costs represent about 12 per cent of costs in the average residential bill (averaged across the five distribution zones).

[50] The Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3.

[51] Simply Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2.

[52] GloBird Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 7.

- We estimate the allowance for retail operating costs for 2021 will decrease slightly compared to the allowance included in our 2020 determination, reflecting adjustments for inflation (notably, a fall in the consumer price index since we made our 2020 determination).

Retail operating costs reflect a range of costs incurred by an electricity retailer in conducting its business, including billing and revenue collection systems, information technology systems, call centre costs, corporate overheads, energy trading costs, provision for bad and doubtful debts, and regulatory compliance costs.[53]

Our draft decision is to use a benchmark approach adjusted for Victoria specific costs

The 2021 allowance for retail operating costs per customer is based on the benchmark of $121.07 set by the Independent Competition and Regulatory Commission in its 2017 final decision for retail electricity prices in the Australian Capital Territory. For our draft decision (and consistent with our past approach) we adjusted this benchmark for the change in the consumer price index (CPI) since 2017 which leads to a benchmark of $125.12. [54]

In addition to this benchmark and consistent with our past approach, we have set an allowance for additional regulatory costs and Victoria specific operating costs of $10. This takes the allowance per customer to $135.12 for 2021. This allowance reflects costs related to operating in Victoria and not covered by the Independent Competition and Regulatory Commission benchmark, including those associated with the payment difficulty framework.[55] We have previously signalled that this additional allowance may be reduced.[56] However, with ongoing uncertainty associated with the pandemic, we propose not to adjust this benchmark at this time.

Our draft decision benchmark of $135.12 per customer is slightly lower than the current (2020 VDO) benchmark, reflecting a reduction in the CPI since our last decision.

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[53] Clause 12(4)(d) of the order requires we have regard to retail operating costs, including modest customer acquisition and retention costs, as an element in developing the efficient costs of the sale of electricity by a retailer. We address customer acquisition and retention costs in the next section.

[54] For our draft decision, the price index for the June 2020 quarter has fallen relative to our last VDO determination. We will update our final decision based on the September 2020 quarter. We use the consumer price index to adjust our retail operating cost benchmark because it is consistent with our past approach, how the benchmark has been treated in the past and is a commonly used approach by other regulators.

[55] Based on the analysis of Victorian specific costs in the ACCC's Retail Electricity Pricing Inquiry final report completed in our final advice to government. For more detail see Essential Services Commission 2019, Victorian Default Offer to apply from 1 July 2019: Advice to Victorian Government, 3 May, p. 64.

[56] Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Draft Decision, September 2019, p. 40.

The benchmark approach is transparent and based on efficient costs

The benchmark approach to calculating an allowance for retail operating costs represents a transparent and simple approach. It is easily replicable and based on public information. This is consistent with the methodology we used in the VDO for 2020 and has been adopted for regulated prices in Queensland and Tasmania.

The level of this benchmark is appropriate because it has been updated for inflation and we have cross checked our approach with actual data provided to us by Victorian retailers.[57] Our analysis of cost data we have collected from retailers suggests the allowance we have set represents an efficient allowance for retail operating costs for retailers of different sizes. However, the data retailers provided in response to our cost data requests covers financial years 2017-18 and 2018-19: so it does not include the effect of the pandemic on retailers' costs.

While we consider the benchmark appropriate at this time, we may consider introducing a productivity factor in future reviews. We have not included a productivity factor for the 2021 VDO due to the uncertainty associated with the pandemic.

We considered the cost to comply with the five-minute settlement rule change

We acknowledge the introduction of five-minute settlement from 1 October 2021 may lead to additional costs for retailers. However, we consider that we have not been provided with sufficient information to justify an increase to the retail operating cost benchmark at this stage.

We have reviewed publicly available information submitted on behalf of the Australian Energy Council to the Australian Energy Market Commission's (AEMC's) five-minute settlement rule change process.[58] We consider this information does not provide sufficient detail to identify the costs that will be incurred by retailers operating in Victoria on an annual basis, as a result of the rule changes.

We invite retailers to provide further information to us on their estimates of cost changes due to the introduction of five-minute settlements. In particular, we are seeking information that would enable us to quantify the impacts of the changes on costs for retailers operating in Victoria, and whether any changes in costs will be sustained. We are also seeking information on the impacts on overall costs to serve, including expectations about productivity improvements arising from implementation of five-minute settlements.

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[57] We used our Section 37 powers under the ESC Act to formally request cost data first in September 2019. While the latest retailer data available to us is for financial year 2017-18 and cost categories do not line up perfectly with the VDO cost stack, we consider this fit for the purpose of determining a sensible range for efficient costs. We are in the process of validating the data that retailers have provided us for 2018-19. The validated data will be available for analysis while we prepare our final decision.

[58] Russ Skelton & Associates, Cost & Price Impacts presented at AEMC Public Forum, May 2017, p. 4.

We have considered the effect of the pandemic on retail operating costs

A number of submissions commented on the effect of the pandemic on retail operating costs. We also received some confidential information from retailers on their forecast bad debts. We have given careful consideration to the matters raised. Retailers' submissions identified two categories of retail operating costs that had increased as a result of the pandemic:

- bad and doubtful debts due to more customers experiencing financial vulnerability[59] and
- increases in costs to serve mostly attributable to
  - working from home arrangements[60] and
  - increases in the volume and complexity of communication with customers.[61]

We have not adjusted retail cost benchmarks to reflect the impacts of the pandemic, as we have insufficient information to justify any changes at this time. The cost estimates provided to us by retailers are based on assumptions about things such as future economic conditions and the extent of government stimulus. In addition, the information that is available to us, at the industry level, does not yet show that the net costs to energy retailers associated with the pandemic will be material.

Critical for our draft decision, retailers did not provide us with information on outcomes for overall costs to serve. We stated that any claims about increases in costs should be accompanied by information about changes in costs to serve at the total level. There is publicly available evidence that electricity retailers have achieved substantial savings in costs to serve in recent years, with further savings forecast.[62]

We note however, ongoing uncertainty about the impacts of the pandemic. We will continue to monitor its impacts in the lead up to our determination and into 2021 by, among other things, using data on the level of customer debt that retailers are already providing us. We welcome additional information from stakeholders, including electricity retailers, to inform our determination. We are especially interested in evidence on how retailers' costs have changed at the total level since the start of the pandemic.

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[59] For example, The Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 5; or Momentum Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3.

[60] GloBird Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 7; or AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3.

[61] Origin Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 5; or GloBird Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 7.

[62] See AGL, ASX announcement – FY20 Results Presentation, 13 August, p. 23; Origin Energy, 2020 Full Year Results Announcement, 20 August, p. 32.

Impacts to bad and doubtful debt for 2021 have a high level of uncertainty

Bad debts include debt write-offs and provisions for doubtful debt, net of debt recovered. Our analysis of retailer cost data shows bad and doubtful debt has made up, on average, about two per cent of customer revenues.[63] The information available to us indicates the impacts of the pandemic on bad debts remains uncertain, but at this stage the increase may not be large.

Publicly available data from the AER shows the number of residential customers with a 90 plus day debt to their retailer is at a similar level to that for recent years.[64] Total debt for residential and small business customers has increased slightly. Data provided to us by retailers for their Victorian operations tells the same story. It also shows there is a big difference between the impacts on large, medium and small retailers in terms of the average arrears of residential customers.[65] Large retailers, who service over 90 per cent of VDO customers, have seen very little change to date. It remains uncertain how trends in arrears will impact on bad debts, and therefore costs incurred by retailers.

Analysis of financial year 2019-20 results published by AGL and Origin Energy indicates their provisions for bad and doubtful debts are a relatively small share of their total costs.

AGL has made provision for credit losses to increase by $20 million nationally in 2019-20 due to the pandemic. With the additional provision, expected credit loss as a proportion of revenue was largely unchanged from the previous year at around 1.5 per cent.[66] Origin Energy reported an additional provision of $38 million for bad and doubtful debt nationally for 2019-20 to account for the impact of the pandemic on both electricity and gas customers. With this provision, bad and doubtful debts as a proportion of revenue increased from a historical average of around 0.70 per cent to 1.09 per cent.[67]

Another relevant consideration is that governments are providing financial support for customers, and this has reduced the impact of the pandemic on retailers. This is primarily through JobKeeper and JobSeeker payments. We note the JobKeeper payment will decrease in late September and again in early January, and is currently scheduled to end in March 2021.[68] JobSeeker

[63] This is based on analysis of retailer cost data for 2017-18 provided to us in a section 37 request under the ESC Act. As footnoted earlier we are in the process of validating data for 2018-19.

[64] See Australian Energy Regulator, Retail market data dashboard – COVID-19, 3 August 2020, p. 1.

[65] Based on analysis of confidential data provided to the Essential Services Commission for Energy customer support during the coronavirus pandemic reporting.

[66] AGL, ASX announcement – FY20 Results Presentation, 13 August, p. 24.

[67] Origin Energy, 2020 Full Year Results Announcement, 20 August, p. 58.

[68] https://treasury.gov.au/sites/default/files/2020-08/Fact_sheet-JobKeeper_Payment_extension_1.pdf

supplementary payments will be reduced in September and end in late December 2020.[69] However, these additional payments are likely to mitigate (to some extent at least) the impacts on bad debts and other costs associated with managing financially vulnerable customers. Survey data from the Australian Bureau of Statistics indicates that of Australians who received a stimulus payment, the main use in June was to pay household bills.[70] Further, the survey found three in five people who were unemployed or not in the labour force had received a stimulus payment by June.

There is uncertainty around the nature of government support for customers in 2021. This uncertainty makes it difficult to forecast cost impacts. Our engagement with retailers on the effect of the pandemic confirmed the high level of uncertainty around projections of bad debt, with several submissions indicating that the effect of the pandemic could not be accurately measured and may not be understood until mid-2021.[71]

As such, any forecasts for bad debts would rely heavily on assumptions and limited data. We consider that there is insufficient justification to increase the retail operating cost benchmark due to the impacts of the pandemic on bad debts. We do not think customers should pay more to reflect uncertainty about the impacts of the pandemic on bad debts and retailer costs.

We have not received sufficient evidence to adjust our benchmarks for other costs arising from the pandemic

A number of retailers made submissions about the increased operating costs due to work from home arrangements and an increase in the volume and complexity of customer interactions. We recognise that where retailers have made submissions about cost changes due to the effect of the pandemic, generally these changes are a response to support their staff or customers.

However, our engagement with retailers indicated they found the changes in costs difficult to quantify and we note little data or evidence quantifying increases was provided in submissions. Nor was there sufficient evidence that any changes in costs would be sustained.

Some retailers reported one-off IT costs to supply laptops and other systems to facilitate staff working from home and comply with social distancing health policies. However, these one-off costs are not industry wide, and a number of retailers reported having made these investments in previous years. Further, these one-off IT costs will generally not continue into 2021. It is also unclear whether the investment in IT capabilities will result in efficiencies and other cost savings such as lower spending on office spaces.

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[69] https://www.servicesaustralia.gov.au/individuals/services/centrelink/jobseeker-payment/how-much-you-can-get

[70] Australian Bureau of Statistics, 4940.0 Household Impacts of COVID-19 Survey, Detailed Release, June 2020.

[71] For example, Red and Lumo Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; Origin Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3.

Some retailers reported increases in the complexity and volume of incoming calls. Again, we note this is not industry wide. A number of large retailers have previously invested in systems that allow other forms of engagement, aside from call centres, which are more efficient. Further, while the volume and complexity of some types of incoming calls may have increased, retailers reported it was hard to quantify whether this represents a significant change in costs.

Further, to the extent there may be increases in costs, retailers did not provide us with information on trends in overall costs to serve, as requested in our consultation paper.

A review of information reported in 2019-20 financial year results suggest any increase in costs arising from the pandemic could be outweighed by ongoing savings due to efficiency gains. AGL reported $135 million of national recurring cost savings achieved over the previous two financial years[72], while Origin Energy reported achieving $73 million nationally in retail costs to serve savings over the same period, a reduction of almost 12 per cent from 2017-18 financial year baseline costs.[73]

This suggests there could be merit in applying an annual productivity factor to the VDO retail cost benchmarks, as we have flagged in previous reviews. We have not adopted such a factor in our draft decision, given uncertainty associated with impacts of the pandemic on costs.

For us to change our position on the impact of the pandemic in our final decision we would need to have evidence that retailers' costs had increased at the total level. However, even if we had that evidence we could only adjust our benchmarks for cost changes due to the effect of the pandemic if we consider this approach best meets the legislative considerations that we must have regard to, as outlined in Appendix C.

Customer acquisition and retention costs

- Our draft decision is to retain our approach to estimating customer acquisition and retention costs (CARC), updating for inflation.
- CARC represent about three per cent of costs for the average residential bill (averaged across the five distribution zones).
- Our decision means CARC in the cost stack would slightly decrease.

The pricing order requires us to include a modest allowance for CARC in making our VDO price determination.[74] Our allowance reflects the costs of competing for customers in a contestable retail

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[72] AGL, ASX announcement – FY20 Results Presentation, 13 August, p. 23.

[73] Origin Energy, 2020 Full Year Results Announcement, 20 August, p. 32.

[74] Clauses 12(3) and 12(4) of the order.

market. These costs include the cost of acquisition channels (such as third-party comparison websites and service providers or telemarketing sales), the cost of retention teams, and marketing costs targeted at driving customer acquisition or retention.

We propose to retain our approach to setting an allowance for CARC

Our draft decision is to retain our benchmarking approach to set a modest allowance for CARC, based on cost levels from recent regulatory decisions, findings from the Australian Competition and Consumer Commission's Retail and Electricity Pricing Inquiry final report and information from retailers on their reported costs, updated for inflation.

We consider this is appropriate due to the level of uncertainty facing the retail electricity industry in Victoria due to the ongoing pandemic. While some parts of the CARC might be decreasing because of the pandemic, others may be increasing. Until we have more information on the size of these changes, we consider it is too early to change our approach on CARC.

However we note that in future reviews we will give further consideration to reducing CARC where warranted. Based on AEMO data, we note that retail electricity customer churn in Victoria has trended downwards over the past two years. During April 2020, customer churn levels reached a two-year low but have subsequently risen.[75] In our May 2019 advice to government, we noted that increased CARC expenditure had occurred while customer churn rates in Victoria remained relatively constant.[76] This may indicate retailers' CARC spending may not be a driver of capturing or retaining customers.

We have considered stakeholders' submissions on CARC

Consumer Action Law Centre submitted that we should conduct market research on what customers value and use this to determine whether retailer spending on CARC is modest. Consumer Action Law Centre also proposed that we should reduce the level of the benchmark for CARC.[77]

Alinta Energy supported our proposal to continue using our benchmark methodology to estimate an allowance for CARC.[78] EnergyAustralia submitted that our approach to estimating an allowance

[75] AEMO, National Electricity Market Monthly Retail Transfer Statistics, accessed 10 August 2020, https://aemo.com.au/-/media/files/electricity/nem/data/metering/mrts/2020/nem-monthly-retail-transfer-statistics-202007.pdf?la=en

[76] Essential Services Commission, Final advice to the Victorian Government on the Victorian Default Offer to apply from 1 July 2019, May 2019, p. 68.

[77] Consumer Action Law Centre, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 7-8.

[78] Alinta Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3.

for CARC, based on the 'modest' definition set out in the pricing order, is a drag on competitive market outcomes.[79]

Other costs

- Our draft decision is to make an allowance for other regulatory costs that are based on the latest available market information and represent around one per cent of total costs for a representative customer (averaged across the five distribution zones).
- Our draft decision would marginally decrease the allowance for these costs compared with the current VDO.

Other regulatory costs include a range of discrete and specific costs that retailers incur outside of costs to serve. They are generally minor relative to the total cost stack (around one per cent) but are a relevant factor in our estimation of the efficient costs for the sale of electricity by a retailer.[80]

Australian Energy Market Operator fees

These fees are charged to recover the costs of market operation and full retail contestability functions. It also includes costs recovered for Energy Consumers Australia.

The AEMO Energy Market Budget and Fees report contains budgeted fees and charges for 2020-21 but does not include forecast estimates for 2021-22. As such, we plan to apply the budgeted fees for all of 2021 and monitor any changes to fees introduced from 1 July 2021. We note that we have also only included the portion of AEMO fees that are levied on retailers. This excludes the portion charged to generators.

The one exception to this is the charges associated with the National Transmission Planner functions. These charges are now levied only on transmission network businesses.[81] As such, we have removed them.

Ancillary fees

Ancillary services are used by AEMO to manage the power system safely, securely and reliably, with respect to standards such as frequency, voltage and system restart processes. Unlike other charges, AEMO operates separate markets for various ancillary services.

[79] EnergyAustralia submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 5.

[80] Clause 12(4)(f) of the order.

[81] Australian Energy Market Operator, 2020-21 Final Budget and Fees, p.26.

The relevant charges are dependent on the amount of service required at any particular time, which means the costs will vary from period to period. We have completed analysis of AEMO data to estimate Victorian ancillary charges in the regulatory period beginning 1 January 2021. We intend to use an average of the past 52 weeks (ending 25 July 2020) of ancillary service payments in Victoria, this results in an average ancillary service payment of $0.42/MWh.

Reliability and Emergency Reserve Trader costs

The Reliability and Emergency Reserve Trader is a function conferred on AEMO to maintain power system reliability and system security using reserve contracts. As this is a separately levied cost on market participants (including retailers), we have included the latest cost data in the VDO. Our draft decision makes an allowance of $2.43 per customer.[82]

Essential Services Commission licence fees

Electricity retailers are charged an annual licence fee to sell electricity to Victorian consumers. Licence fees are based on the costs we incur in performing our regulatory functions. The specific fee for each retailer is contingent on the number of customers served by that retailer.

We propose to use a market wide average of all retailer licence fees in estimating the cost of a licence fee for the VDO. The latest available data on licence fees is from 2018-19 (updated for inflation), which results in an allowance of $0.97 per customer. If newer data becomes available we will include this in our final decision.

We have not made allowances for proposed other new regulatory costs

A number of submissions from retailers proposed that we should make a separate allowance for the costs of transitioning to five-minute settlement in the National Electricity Market. As the costs associated with this transition are not separately charged by AEMO we have considered these as part of our allowance for retail operating costs.

AGL also raised the cost of an AEMO direction in Victoria in the first quarter of 2020, with an estimated cost of $17.5 million.[83] Without further detail about how retailers have been directly impacted by this direction we do not propose to allow for this cost in our draft decision but are investigating the matter further with AEMO.

[82] As noted by AEMO, these are an estimate of the average cost to customers and they do not have visibility of how these costs are passed on to end users. We believe this approach continues to be the most simple and transparent option.

[83] Australian Energy Market Operator, Quarterly Energy Dynamics Q1 2020, April 2020, p. 27.

Retail operating margin

- Our draft decision is to continue to use the benchmarking approach to the retail operating margin we used to determine the VDO which commenced on 1 January 2020
- Retail operating margin represents about 5.7 per cent of costs for the representative user.
- Our draft decision would mean that the dollar value of the retail operating margin in the cost stack will slightly decrease.

The pricing order requires us to have regard to retail operating margin when making a VDO price determination.[84] We considered how the pandemic will affect retailers' margins and whether or not the level or methodology of the retail operation margin in the VDO should change to reflect this. Our draft decision is to maintain the approach we used to setting the retail operating margin in our last review.

Retail operating margin provides retailers incentives to invest

Retail operating margin represents the operating profit margin required to compensate investors for the capital provided to operate a retail service. It should be sufficient to cover the cost of capital, and the systematic (non-diversifiable) risk associated with investment.[85] The retail operating margin is expressed as a percentage of the cost stack.[86] The pricing order notes that risks accounted for in other components of the cost stack (such as wholesale electricity market risk) must not be included in the retail operating margin[87], and that we are not required to base retail operating margins on actual retailer operating margins.[88]

In our draft decision we have kept the retail operating margin at 5.7 per cent

We have retained the benchmarking approach used in our final decision on the VDO which commenced on 1 January 2020. This approach uses recent regulatory decisions by Australian regulators to set an allowance for a retail operating margin. The evidence before us does not

[84] Clause 12(4)(e) of the order.

[85] Non-diversifiable risks are considered to be unavoidable and are typically attributable to market factors that affect all firms.

[86] The retail margin represents the return that an electricity retailer requires, over and above its costs, in order to attract the capital needed to provide a retailing service. The term margin is used as an estimate of profit (EBITDA) divided by sales. Holding the percentage EBITDA margin constant means that if energy, network and operating costs rise over time, the dollar margin will also rise, reflecting an increase in the required capital in dollar terms.

[87] Clause 12(7) of the order notes that in determining retail operating margin we must have regard to the principle that the margin must not compensate retailers for risks that are compensated elsewhere in the costs.

[88] Clause 12(9) of the order.

suggest there has been a material, and ongoing, need to increase the retail operating margin. As a result, we do not propose to make an adjustment to the retail operating margin for the impact of the pandemic at this time.

We considered how the pandemic will affect retailers' margins

The impact of the pandemic will affect retailers of different sizes differently

At the industry level, there is some evidence that borrowing costs may have decreased. With the RBA cash rate at historic lows, the cost of borrowing for larger retailers may be below long-term trends. However, we also note that this may not be the case for smaller retailers that do not have access to low cost lines of finance. Additionally, in setting the retail operating margin, we must estimate efficient costs not the actual costs of retailers.

Systematic risk is also already accounted for in the retail operating margin

The retail operating margin covers among other things retailers' cost of capital. The cost of capital includes remuneration for systematic risk through the market risk premium. Systematic risks include the risk of long-term economy wide downturns such as would be caused by the business cycle, financial crisis, war or a pandemic. As a result, the retail operating margin is set on the assumption that economic downturns, such as those caused by a pandemic, will occur.

Due to the lack of available data, it is still unclear whether systematic risk has materially changed as a result of the pandemic, but in the short term investors' appetite for risk may have. Increasing the retail operating margin, at this stage, could double count the premium for systematic risk already included in the retail operating margin.

Additionally, our retail operating margin is already set at the upper end of the benchmark range.

We considered stakeholders' submissions on the retail operating margin

The majority of submissions came from retailers and related to the level of the retail margin allowance, rather than the benchmarking approach itself.

Stakeholders also raised some matters that we had previously considered but provided no new evidence to support their positions.

The impacts of the pandemic

A number of retailer submissions suggested that the retail operating margin should increase due to a change in the risks faced by retailers such as increased customer defaults and bad debts.[89]

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[89] AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4; EnergyAustralia, submission to the Essential Services Commission Victorian Default

The Consumer Action Law Centre submitted that we should not set a precedent by offering retailers a special allowance to deal with the pandemic in the absence of strong evidence that costs have increased, and that they are different from the inherent risks retailers manage already.[90]

For the reasons discussed above we consider that there is not sufficient evidence to change the retail operating margin at this time.

Some retailers also reported the pandemic had increased their working capital requirements.[91] To the extent that increases in bad debts will lead to increases in working capital, that should be dealt with through retail operating costs. As the retail margin applies to retail operating costs, an increase in retail operating costs would be reflected in a corresponding increase in the dollar amount of the retail operating margin.

Undertaking a new benchmarking study

The Consumer Action Law Centre also recommended that we conduct independent modelling to determine an appropriate benchmark for an efficient retail operating margin and set the allowance at the lowest point of any range given.[92]

Given the uncertainty around costs due to the pandemic, we will not revisit our approach to the retail margin at this time. However, we may consider it further in future reviews.

Retailer profitability

At this stage, we consider that the retail margin continues to provide the right incentives to invest in electricity retailers.

We continue to receive new retail licence applications

The number of retailers continues to grow. Evidence of this is that during the pandemic we have received 4 applications for retail licences. This suggests that investors consider that it is still profitable to enter the electricity retail market.

Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; Red and Lumo Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; and Origin Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4.

[90] Consumer Action Law Centre, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3.

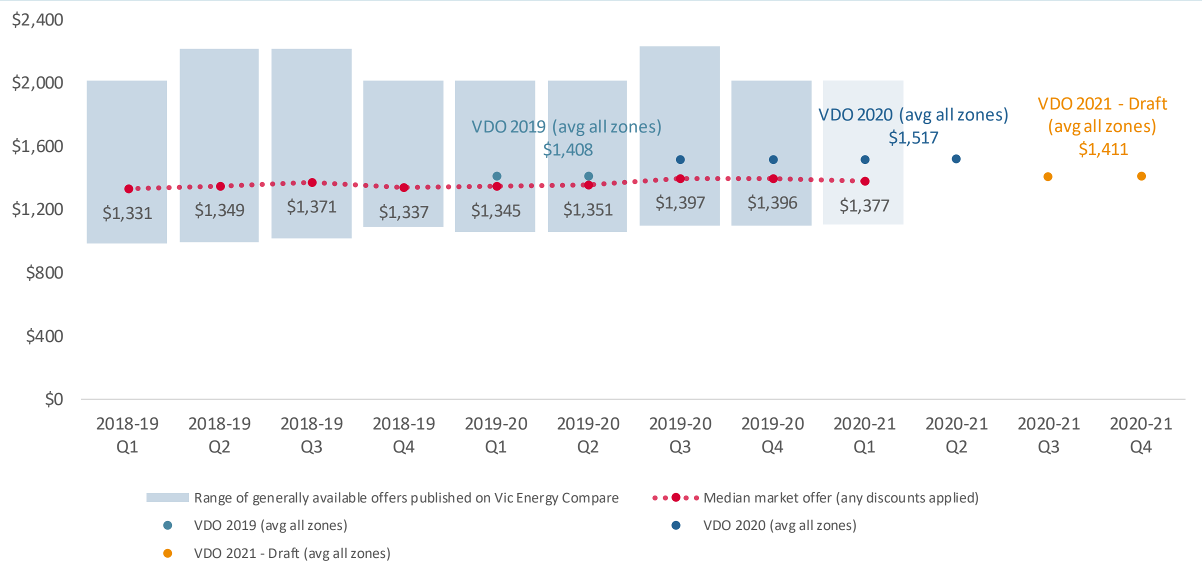
[91] amaysim, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; Powershop and MEA Group, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3; and GloBird Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 7.

[92] Consumer Action Law Centre, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 8.

During the pandemic retailers continue to provide market offers below the VDO

We have also observed how VDO prices compare to the market offers currently available from retailers. We note that the median market offer has gone down since the beginning of the pandemic. If the profitability of retailers were threatened, due to the cost impact of the pandemic, we would expect to see the median market offer go up. Figure 4 compares the median market offer to the average residential VDO bill. We observe a similar pattern in the data for small business customers.

Figure 4: Annual residential VDO bill compared to market offer bills (4,000 kWh/year)



Calculating the VDO tariffs and maximum bill

- Our draft decision is to use the approach we used in making our determination on the 2020 VDO for calculating VDO flat tariffs and the maximum bill.

The pricing order requires us to determine:[93]

- the tariffs, or the maximum tariffs, a retailer may charge prescribed customers under a standing offer during the regulatory period or
- the manner in which the tariffs, or the maximum tariffs, a retailer may charge prescribed customers under a standing offer during the regulatory period are to be determined or calculated.

For the first determination, after we estimated the cost of providing a retail electricity service, we turned the costs into prices for the VDO using two different methods:

- **flat VDO tariffs -** for standing offers with flat tariffs, and
- **the maximum bill -** for standing offers with non-flat tariffs.

Consistent with our consultation paper, our draft decision is to continue to use flat VDO tariffs for standing offers with flat tariffs and the maximum bill for standing offers with non-flat tariffs.

Tariff structure

Because of underlying network charges, almost all tariffs contain a fixed, daily supply charge and a variable, per kilowatt hour charge. However, unlike the supply charge, the variable charge component can be structured in different ways and this determines how a customer is charged for the energy they use.[94]

Under a flat or anytime usage tariff, customers are billed the same amount for each kilowatt hour of electricity they use at all times of the day. In contrast, non-flat tariffs have different rates for electricity used at different times of the day. Under a time-varying tariff structure, using energy during times of peak and shoulder demand is more expensive. There can also be further differences in these prices between weekdays and weekends.

[93] Clause 10(1) of the order.

[94] Victorian DNSPs have proposed moving to more cost reflective tariffs in the upcoming regulatory period. This is discussed further below and in the networks tariff section of this decision.

Although this variety provides customers with different options, it also increases the complexity of some tariffs and requires a customer to have a thorough understanding of how their own pattern of electricity use will be reflected in their bill when it arrives.

Our draft decision on flat VDO tariffs

Our draft decision is to use the same approach to setting standing offer rates for flat tariffs as we did in our 2020 VDO determination. Under this approach, we align the VDO tariff structure with the underlying flat network tariffs in each distribution zone.

We are also guided by the objectives of the pricing order, which states the VDO is to provide a simple, trusted and reasonably priced option for customers unable or unwilling to engage in the market.[95] As set out in our consultation paper, we propose that this objective is best satisfied by setting VDO tariffs with a daily supply charge, and a flat, anytime usage charge as in the current VDO regulatory period. Where relevant for domestic customers, we have also set a controlled load charge. This is largely due to the relative complexity and variety[96] of non-flat tariff structures.

Submissions to our consultation paper generally supported our approach to VDO tariffs for standing offers with flat tariffs.[97]

Cost allocation

To set the rates for flat tariffs, we must identify how costs should be allocated within that structure.

Consistent with our previous VDO determination, we propose a simple and logical method to allocating costs with fixed costs contained in the daily supply charge and any costs that vary with usage making up the variable, per kilowatt hour charge component of the VDO tariffs:

> Daily supply charge (fixed costs) =
>
> (retail operating costs, including customer acquisition and retention + fixed network costs +
>
> per customer ancillary and feed in tariff social cost of carbon) x (1 + retail operating margin)

[96] There are a number of potential variations arising from when peak, shoulder, and off-peak times are set and also on which days of the week these times apply.

[97] AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 6; The Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2-3; Alinta Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2.

Usage charge (variable costs) =

(wholesale electricity costs + environmental program costs + variable ancillary costs +

electricity network losses + variable network costs) x (1 + retail operating margin)

Calculation of VDO tariffs

As described in the formulas included above, we set the VDO tariffs by calculating fixed rates charged per day and variable rates charged per kilowatt hour. The methodology and approach we propose to use to estimate the costs that will underpin these calculations are covered in the chapter on the VDO cost components.

The maximum bill

In addition to setting the flat tariffs described above, our draft decision is to regulate standing offers with non-flat tariffs (for example, time of use and demand tariffs) through a compliant maximum annual bill. This is consistent with the approach we took to making our determination on the 2020 VDO. In our last VDO determination we were required to use a maximum bill to regulate non-flat standing offer tariffs. However, the requirements for subsequent decisions (including this one) allow us to determine another manner to determined or calculate non-flat standing offer tariffs.[98]

Our draft decision is to maintain our current approach to the maximum customer bill

Our draft decision is to apply a compliant maximum annual bill for non-flat standing offer tariffs. Retailers choosing to offer non-flat standing offer tariffs will be required to ensure that their tariffs will not result in a bill above the maximum at that usage amount. This is consistent with the approach we took to making our determination on the 2020 VDO and we consider this approach best meets our obligations under the pricing order.

Taking this approach retains the safeguard of the VDO to all standing offer customers without removing the option of non-flat tariffs from customers currently receiving them. It will also provide flexibility for retailers to continue to offer retail tariffs that reflect the structure of underlying network tariffs, and to promote cost reflective pricing.

[98] Clause 10(3) of the order.

There are also likely to be lower costs associated with the administration of our maximum bill approach than an approach based on individual customer's actual consumption. This supports objectives in the pricing order and ESC Act relating to efficiency.

In our consultation paper, we sought feedback on whether our approach of setting a maximum annual bill continues to provide an appropriate safeguard for customers. We received no clear new evidence in response to our consultation paper to change our position. The greatest concern raised by some stakeholders about our approach was the mismatch between the VDO maximum bill and the underlying costs, suggesting that we should adopt an alternative approach (such as that used by the AER for its Default Market Offer).

Setting the compliant maximum annual bill

Consistent with our current approach, we propose to set the VDO compliant maximum annual bill for standing offers with non-flat tariffs based on the relevant annual reference consumption amount and relevant flat standing offer tariffs determined for relevant customers, assuming a 365-day supply period.

For non-flat standing offers that a retailer chooses to offer, the retailer must demonstrate that its tariffs do not result in an annual bill that exceeds the relevant VDO maximum annual bill amount.

To do this, retailers must adopt the relevant annual reference consumption amount and profile of customer usage. Where a reference profile is not specified, the retailer must provide relevant usage allocations that are reasonably representative of usage by customers on that tariff type over a 365-day period.

Annual reference consumption amount

The annual reference consumption amount used to determine the VDO compliant maximum annual bill amount is as follows:

- For domestic customers, there will be five maximum annual bills (one for each distribution zone), calculated for a representative customer consumption of 4,000 kWh per year.
- For small business customers, there will be five maximum annual bills (one for each distribution zone), calculated for a representative customer consumption of 20,000 kWh per year.

These annual reference consumption amounts are to be used to calculate whether a retailer's non-flat standing offer tariffs, for a particular tariff type, will result in an annual bill that exceeds the VDO compliant maximum annual bill amount relevant for that tariff type.

Representative usage profiles and related usage allocations

If offering a flexible, five or seven-day time of use (or the 5-day time of day/9pm off peak) standing offer tariff, a retailer must demonstrate those tariffs do not exceed the relevant VDO compliant maximum annual bill based on the representative usage profile for the customer group. See table 2 below.

Table 2 – Representative usage profiles for specified non-flat standing offer tariff types

Specified non-flat standing offer tariff type	Peak	Shoulder	Off-peak
Flexible price (3 part time of use)	0.25	0.45	0.30
5-day time of use	0.52	0.00	0.48
7-day time of use (small business customers only)	0.74	0.00	0.26
5-day time of day 9 pm off peak (United Energy distribution zone only)	0.25	0.20	0.55
5-day time of day (United Energy distribution zone only)	0.32	0.20	0.48

For any other non-flat standing offer tariff, a retailer must demonstrate that these tariffs do not exceed the relevant maximum annual bill by using a representative usage profile, or relevant usage allocations, reflecting an estimate of consumption for the relevant group of customers in the 12-month period beginning 1 January 2021.

Publishing requirements

Retailers must publish all standing offers for the regulatory period beginning 1 January 2021 (including the flat standing offers we determine) in the government gazette. For non-flat standing offer tariffs, other than five or seven-day time of use tariffs, the retailer must also publish the usage profiles used to demonstrate those tariffs do not exceed the relevant maximum annual bill in the government gazette.

We considered stakeholders' submissions on the maximum bill

In our consultation paper, we sought input from stakeholders on options for setting non-flat standing offer tariffs that would fulfil the objective of the VDO and whether our approach of setting a maximum annual bill amount based on the flat VDO tariffs at a representative customer usage continues to provide an appropriate safeguard for customers while meeting our statutory obligations. We also asked specific questions about evidence of customers choosing to take up non-flat standing offers and observations from stakeholders about their experiences with comparing these offers with the maximum bill amount.

Stakeholders raised a number of matters we considered in making our determination for the 2020 VDO without providing any strong new evidence.[99] The greatest concern repeated by some stakeholders about our approach was the mismatch between the VDO maximum bill and the underlying costs. Some stakeholders proposed that a simple solution would be to allow retailers to either obligate Victorian network businesses to change a customer's non-flat network tariff to a flat tariff or allow retailers to assign customers to flat network tariff structures where they choose the VDO. We note both approaches require a change to the regulatory framework which is outside the scope of this VDO price determination.

Related to the matter of underlying costs, stakeholders said we should consider the effect of Victorian network businesses introducing default two-rate time of use tariffs for residential and small business customers from 1 July 2021.[100] At this stage we do not propose to change our approach to the maximum bill in response. This is because:

- to begin with, these tariffs will only apply to a small number of customers and[101]
- it is uncertain whether the AER will approve those proposals, and if it does whether it will require any changes.

We may consider this matter further in future reviews or through a variation to our determination.

[99] Next Business Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; Tango Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; Simply Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4; Powershop and MEA Group, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4.

[100] AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 6; The Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2-3; Alinta Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; Powershop and MEA Group, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4.

[101] The Victorian network businesses are proposing that the new time of use tariffs will apply to customers requesting the following services: new connections; 3 phase meter upgrades; and new solar connections. Customers (excluding solar customers) can request to opt-out to a single rate tariff. Customers on existing tariffs can opt-in to the new time of use tariff.

Other considerations

Length of the regulatory period

- Our draft decision is to set the 2021 VDO regulatory period for the 12 months 1 January 2021 to 31 December 2021.

The regulatory period for electricity networks is changing

As set out in our consultation paper, the Victorian Government has signalled its intent to align the regulatory periods for the Victorian network businesses with those for other jurisdictions to run on a financial year basis. Our consultation paper noted the link between VDO regulatory periods and Victorian network businesses regulatory periods. We also sought stakeholder feedback on whether we should change the length of the VDO regulatory period beginning 1 January 2021 to six or 18 months.

Requirements in the pricing order

The pricing order sets out that the regulatory period for a VDO determination is 12 months. Currently, VDO regulatory periods run for a calendar year. However, the pricing order provides for the regulatory period to be extended or reduced by six months if special circumstances exist. We must consult with the Minister for Energy, Environment and Climate Change before changing the length of the regulatory period.

For practical reasons we propose a 12-month period

As network costs make up a significant component of the VDO cost stack (between 35 and 43 per cent for residential customers depending on the network zone), it is important that we accurately reflect these costs in our determination. This is particularly the case under our approach to network costs where we allow retailers to pass through these costs to customers.

In response to aligning the Victorian network businesses' regulatory periods with other jurisdictions on a financial year basis, the current network regulatory period is proposed to be extended by six months to 30 June 2021 before the new five-year determination comes into effect from 1 July 2021. These changes require passage through Victorian parliament to give effect through legislation. Assuming this occurs, the AER is aiming to make its final decision on the Victorian network businesses' regulatory proposals for the regulatory period 1 July 2021 to 30 June 2026 by 30 April 2021 and the network businesses will have to 31 May 2021 to publish their network tariffs that apply from 1 July 2021.

If the second VDO determination period is set for six-months (1 January to 30 June 2021), for our decision on the following VDO determination (1 July 2021 to 30 June 2022) we would have to make our final determination at least 37 days before the commencement of a regulatory period, or 25 May 2021 for a 1 July 2021 commencement date.[102]

Regardless of this constraint, the network businesses have until 31 May to publish their final tariffs. Therefore, for a VDO regulatory period 1 July 2021 to 30 June 2022 it is highly probable that final network tariffs applicable from 1 July 2021 would not be reflected in our final determination due by 25 May 2021 and we would need to include an estimate of what the tariffs will be.

This is a similar position to a 12-month VDO regulatory period commencing 1 January 2021 where we would also have to include an estimate. This uncertainty is best addressed through a variation mechanism (discussed in the next section).

An 18-month period shares the same difficulty accounting for network costs with the added disadvantage of requiring us to change and consult on how we forecast a number of different parts of the VDO cost stack. This would require more time, and given the coronavirus pandemic, there would also be a risk of this leading to greater separation between our cost stack benchmark and efficient costs.

Taking these matters into account, we consider that the 2021 VDO regulatory period should be for 12 months and that we deal with uncertainty around the network tariffs that apply from 1 July 2021 through the variation mechanisms in our VDO price determination. We propose to align future determinations with the Victorian network businesses regulatory periods with either a six or 18-month regulatory period followed by annual 12-month regulatory periods.

We considered stakeholders’ feedback on our consultation paper

In our consultation paper, we sought stakeholder feedback on whether we should change the length of the regulatory period beginning 1 January 2021 to six or 18 months.

All but one stakeholder that provided feedback on the length of the regulatory period supported changing the 2021 VDO to a six-month regulatory period from 1 January to 30 June 2021, followed by 12-month regulatory periods.[103] Generally, they noted that this approach not only would align

[102] Clause 10(1) of the order.

[103] The Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 6; AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; Alinta Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3; amaysim, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3; Consumer Action Law Centre, submission to the Essential Services Commission

the VDO regulatory period to the network pricing regulatory periods, but it would also provide an opportunity to better quantify any increases in retail costs resulting from the pandemic. It was noted by stakeholders that while the introduction of a six-month regulatory period is more administratively cumbersome, it was outweighed by the benefits of aligning to the new network pricing regulatory periods. Some stakeholders considered that an 18-month regulatory period would pose too high risk to retailers.

We understand and accept the benefits of a six-month regulatory period outlined by stakeholders. However, on balance, we consider that using a variation mechanism will better address stakeholders' concerns than a six-month regulatory period.

Variation mechanism

Our draft decision is to:

- carry forward the 2020 VDO price determination variation mechanisms into the 2021 VDO price determination
- nominate the Australian Energy Regulator's (AER) approval of network tariffs as an event that would lead us to consider a variation to our determination.

The pricing order specifies that before or during a regulatory period, the we may, on our own initiative, vary a VDO price determination in respect of the regulatory period.[104] However, we must specify, in the VDO price determination, the circumstances under which we will consider and the basis on which we will decide on a proposed variation. We must also specify the processes to be followed to enable us to make such a variation.

We included a mechanism that provided for variations to the 2020 VDO price determination in the event of a material unforeseen change or error that:

Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 8; EnergyAustralia, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 8; GloBird Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 8; Powershop and MEA Group, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4; Origin Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 5; Red Energy and Lumo Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3; Simply Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4; Next Business Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; Tango Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3;

[104] Clause 13(1) of the order.

- was sufficiently uncertain or unforeseen at the time of making the price determination – such as an exogenous shock,[105] and
- was sufficiently material to impact the benchmark established for the efficient costs to supply an electricity retail service.[106]

The 2020 VDO price determination also allowed us to make a variation to a VDO price determination to correct a clerical error, miscalculation, misdescription or other deficiency.

We will continue to use the 2020 VDO variation mechanisms

We consider the existing variation mechanisms continue to be appropriate. We consider that an existing variation mechanism in the VDO determination could be used to make an adjustment during the 2021 regulatory period to account for uncertain, unforeseen and material, impacts of the pandemic, if warranted. In any variation process, we would have regard to all relevant matters under the ESC Act, EI Act and the pricing order and the procedural requirements of the ESC Act and the pricing order (including those related to consultation with stakeholders).

A variation for changes to network tariffs

Network tariffs for the first half of 2021

As noted above, in response to aligning the Victorian network businesses regulatory periods with other jurisdictions on a financial year basis, the current network regulatory period is proposed to be extended by six months to 30 June 2021 before the new five-year determination comes into effect from 1 July 2021. The AER expects to approve network tariffs for the first six months of 2021 by mid-November 2020, in time for us to incorporate these tariffs into our VDO determination. Approved tariffs for the second half of 2021 will not be available until late May 2021.

Our draft decision has used the 2020 network tariffs approved by the AER, unadjusted for inflation in our determination.[107] We will update these for the approved tariffs in our determination.

Network tariffs for the second half of 2021

The final network tariffs approved by the AER for the second half of 2021 will not be available until late in May 2021. We propose that the approval of these tariffs by the AER would be an event that

[105] An exogenous shock here refers to an event that occurs outside the control of a retailer or the industry.

[106] Essential Services Commission, Victorian Default Offer Price Determination 2020: 1 January 2020 – 31 December 2020, 18 November 2019, clause 6 (2).

[107] This aligns with the AER's approach if it is unable to approve tariffs for the six-month period beginning 1 January 2021.

leads us to consider a variation to the VDO determination. Any subsequent variation would account for changes in the level of network tariffs, and possibly the structure of network tariffs.

Victorian distribution networks have proposed to introduce more cost reflective network tariffs from 1 July 2021. Distribution networks' tariff structure statements for the next AER regulatory period indicate that new time-of-use tariffs will apply to:

- new connections
- customers already on flexible tariffs, and
- customers upgrading from single phase to three-phase meters or installing solar or battery technology.[108]

This suggests any changes to the structure of network tariffs will likely affect a relatively small number of customers, of which customers on the VDO will only be a small share.

The pricing order provides that we may decide the nature and extent of stakeholder consultation we will undertake when making a decision to vary a VDO price determination.[109] We are also required to have regard to our Charter of Consultation and Regulatory Practice.

We plan to consult with stakeholders in our consideration of a variation. We expect greater consultation will be required for more substantive changes to network tariffs, including in terms of their structure. However, where there are minimal changes to tariff structures, we anticipate running a shorter consultation process with stakeholders. We propose to treat any change in the total revenue recovered through network tariffs as a cost pass through. Significant changes to the structure of tariffs may require further consultation.

We note clause 13 of the pricing order allows us to vary a determination without consulting, if the variation is not sufficiently material to warrant consultation, or the need for the variation is sufficiently urgent to warrant consultation.[110]

We seek feedback from stakeholders on circumstances where they consider we may not need to consult further, in the context of varying our determination to reflect the AER's final approval of network tariffs applying from 1 July 2021. This could be for example, where there are minimal changes to the structure of network tariffs that need to be considered for the 2021 VDO.

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[108] AusNet Electricity Services, Tariff Structure Statement 2022-26, 31 January 2020, pp. 7-8; CitiPower, Tariff Structure Statement 2021-2026, 31 January 2020, pp.4-5; Jemena Electricity Networks, Tariff Structure Statement, 31 January 2020, pp. 13-14; Powercor, Tariff Structure Statement 2021-2026, 31 January 2020, pp. 4-5; United Energy, Tariff Structure Statement 2021-2026, 31 January 2020, pp. 4-5.

[109] Clause 14(1) of the order.

[110] Clause 13(5) of the order.

We considered stakeholders' feedback on our variation mechanism

Network tariffs

AGL supported our proposal to pass through network costs in line with our previous VDO determinations. However, AGL did note some concerns regarding the process and timing of the determination, submission and approval of Victorian network costs for 1 January 2021. Specifically, any delays in the timing of this process will impact on our ability to use approved network prices in our determination on 25 November 2020.[111]

Alinta Energy said that the most up-to-date and relevant cost data should be used where possible in determining components of the VDO cost stack.[112]

As noted above, we have proposed to treat the AER's final price approval for the 2021-2026 network regulatory period as an event that may lead to a variation of the VDO price determination.

Potential impacts of the coronavirus pandemic

Most stakeholders raised the impacts of the pandemic on the Victorian community and industry.

The Australian Energy Council proposed that we should estimate the predicted rate of non-payment, driven primarily by the Victorian unemployment rate and any ongoing limitations on retailers' ability to recover debts over and above what is in the regulatory framework.[113]

Retailers raised concerns about increased costs resulting from the pandemic, particularly those relating to bad and doubtful debts, and other retailer operating costs.[114]

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[111] AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4.

[112] Alinta Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3.

[113] The Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 5.

[114] AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3; Alinta Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; amaysim, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; EnergyAustralia, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 7; GloBird Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 7; Powershop and MEA Group, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3; Momentum Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3; Next Business Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2; Origin Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3; Red and Lumo Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 1; Simply Energy, submission to the Essential Services Commission

The Victorian Council of Social Service also noted that retailers are likely to be facing extra costs as a result of the pandemic but said we need to ensure that any additional costs related to the pandemic are robustly justified.[115] Similarly, the Consumer Action Law Centre said we should not provide retailers with a special allowance for the pandemic unless there is strong evidence that it has caused a material increase in costs and that any driver of an increase is tangibly different from the inherent risks retailers carry in their role providing risk-management services for customers.[116]

Origin Energy and amaysim said currently they are not able to fully measure the impact the economic fallout will have. Both retailers further noted that the withdrawal or reduction in government support over the coming months will further exacerbate the impacts on customers and retailers.[117] Momentum Energy also acknowledged the difficulties in quantifying the impact of the pandemic.[118]

Comments on how to deal with the uncertainty of the pandemic

Origin Energy supported the proposed variation mechanism as a way of addressing unforeseen changes in costs during 2021, particularly those related to the impacts of the pandemic.[119]

AGL also supported the inclusion of a variation mechanism but said it is unlikely to be utilised apart from in exceptional circumstances. AGL said that a six-month regulatory period would preclude the need for a variation mechanism in the 2021 VDO determination.[120]

Simply Energy said that due to the time-consuming nature of using a variation mechanism, it would be unlikely to be effective in addressing risks faced by retailers from unexpected increases in costs.[121]

Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3 and Tango Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 1.

[115] Victorian Council of Social Service, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2.

[116] Consumer Action Law Centre, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3-4.

[117] Origin Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3; amaysim, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 2.

[118] Momentum Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 3.

[119] Origin Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 6.

[120] AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 6.

[121] Simply Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4.

As discussed in the section about our consideration of the length of the regulatory period, we do not consider that a six-month regulatory period is possible. Accordingly, our approach is to utilise the variation mechanism if we consider it is required.

We will also be monitoring the impacts of the pandemic on the electricity sector and the broader economic conditions, including any enduring impacts affecting Victorian electricity customers and industry. In particular we will continue to monitor data on customer debt that retailers are already providing us. We will also consider evidence on changes in efficient costs at the total level that we receive as part of this review.

We consider that this approach coupled with variation mechanisms will allow us to respond accordingly and in a timely way – by reviewing relevant elements of the VDO cost stack – should the need arise. We will consider all relevant factors, including total costs and retail costs, in deciding whether to vary our VDO price determination.

Materiality and the variation mechanism

Origin Energy considered that the mechanism should be applied where there are material impacts on retailer margins but noted that the term 'material', and its application, should be defined.[122] Simply Energy also suggested that the test of materiality should only relate to whether the impact is material to retail costs and margins that are within a retailer's control rather than other components of a customer's bill which are pass through costs. Simply Energy considered that unless this approach was taken, the variation mechanism would not address risks to retailer sustainability.[123]

Our view about what is considered 'material' may change depending on the context. Importantly, a variation will be limited to extraordinary events that have a significant impact on the benchmark of efficient costs of delivering electricity retail services. This is consistent with the approach we take in other sectors and by other regulators in Australia.[124] In determining what is material we would have regard to all relevant legislative considerations including those set out in Appendix C. As part of this assessment, we would consider:

- the impact (positive or negative) on efficient costs

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[122] Origin Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 6.

[123] Simply Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2021: Consultation Paper, July 2020, p. 4.

[124] For example, our 2018 water price reviews, while the ICRC only consider pass through events as part of their annual recalibration process. See ICRC, Final report: Standing offer prices for the supply of electricity to small customers from 1 July 2017, June 2017, p. 62.

- the capacity of retailers to manage the impact until the commencement of the next regulatory period
- the timing and duration of the event, noting the general principle that events occurring later in the regulatory period are less likely to cause us to vary our price determination as these events may be more efficiently dealt with in our price determination for the following regulatory period
- the costs and benefits to retailers and prescribed customers of a variation
- the objectives and requirements of the pricing order, and
- any other matter that we consider relevant and appropriate.

Appendix A: Network tariffs reflected in the VDO

For our draft decision, to calculate network charges we will take the simplest network tariff in each distribution zone, along with the simplest controlled load tariff for domestic customers and the simplest Advanced Metering Infrastructure (AMI) charges for single phase meters as a cost per customer. We have adopted the simplest network tariffs and AMI charges in each distribution zone as they are the most commonly used charges, while the network tariffs flat structure supports the objective for the VDO to be simple and transparent. These are set out below.

Table A.1 Network tariff categories

Distribution zone	Domestic tariff	Small Business tariff
AusNet Services	Small residential single rate, NEE11	Small business single rate, NEE12
CitiPower	Residential single rate, C1R	Non-residential single rate, C1G
Jemena	Single rate, A100/F100a/T100b general purpose	Small business A200/F200a/T200b
Powercor	Residential single rate, D1	Non-residential single rate, ND1
United Energy	Low voltage small 1 rate, LVS1R	Low voltage medium 1 rate, LVM1R

Table A.2 Controlled load network tariff categories

Distribution zone	Domestic controlled load or dedicated circuit tariff code
AusNet Services	NEE13
CitiPower	CDS
Jemena	A180
Powercor	DD1
United Energy	LVDed

Table A.3 Advanced Metering Infrastructure tariff categories

Distribution zone	Advanced Metering Infrastructure charges
AusNet Services	$51.40
CitiPower	$71.30
Jemena	$79.64
Powercor	$67.30
United Energy	$54.23

Appendix B: Calculation of the cost stack

This appendix provides a summary of the key figures required to understand our draft decision on the cost stack we will use to determine the VDO flat tariffs and maximum bill.

Wholesale electricity costs

We engaged Frontier Economics to estimate wholesale electricity costs for 2021 using the method described in the chapter on VDO cost components. This methodology produces an estimate based on a 12-month trade weighted average of future contract prices, assuming hedging strategies that minimise the level of risk, and an allowance for volatility.

These costs vary across Victoria as a result of different customer load profiles in each distribution zone. Calendar year 2021 estimates of the wholesale electricity price and volatility allowance for each zone are displayed in the table below.

Table B1: Wholesale electricity forecasts for 2021, as at 21 July 2020 (GST exclusive)

Distribution zone	Domestic		Small business	
	Wholesale price - 12 month ($/MWh nominal)	Volatility allowance ($/MWh nominal)	Wholesale price - 12 month ($/MWh nominal)	Volatility allowance ($/MWh nominal)
AusNet Services	$96.18	$0.53	$84.83	$0.44
CitiPower	$91.84	$0.46	$88.18	$0.47
Jemena	$100.03	$0.49	$87.35	$0.45
Powercor	$94.20	$0.47	$82.58	$0.39
United Energy	$100.58	$0.50	$89.38	$0.50

Source: Frontier Economics, Wholesale electricity costs for 2021, 27 August 2020

Network losses

When transporting electricity through transmission and distribution networks, some electricity is lost in the process. The percentage lost overall is the total loss factor and represents the additional amount retailers must purchase when serving the consumption needs of their customers. These loss factors are also applied to the LRET, SRES and VEU obligations of retailers.

We have calculated the total loss factor based on the 2020-21 distribution and marginal loss factors published by AEMO.[125]

Table B2: Network losses

Distribution zone	Distribution loss factor (DLF)	Marginal loss factor (MLF)	Total loss factor
AusNet Services	1.0602	0.9992	5.93%
CitiPower	1.0509	0.9978	4.86%
Jemena	1.0394	0.9983	3.76%
Powercor	1.0653	0.9867	5.11%
United Energy	1.0563	0.9963	5.24%

Source: Australian Energy Market Operator, Distribution Loss Factors and Marginal Loss Factors 2020-21

Network costs

Electricity retailers must pay network costs including distribution, transmission and jurisdictional costs. To pay for these costs, electricity distribution businesses charge retailers by way of a network tariff, generally comprised of a fixed daily charge and a per kilowatt usage charge, and an annual per customer metering charge.

As noted in the chapter on VDO cost components, the Victorian Government has indicated its intention to change the timing of the annual Victorian electricity and gas network prices changes. The change would bring Victoria into alignment with the other National Electricity Market states to operate on a financial - rather than calendar - year basis. The intention is for this change to come into effect for the next regulatory control period. This will mean extending the current regulatory period by 6-months to 30 June 2021. Tables B.3 and B.4 show the network tariffs we have

[125] Australian Energy Market Operator, Distribution Loss Factors for the 2020-21 Financial Year, August 2020, p. 13-16; Australian Energy Market Operator, Regional and Marginal Loss Factors: FY 2020-21, July 2020, p. 20-24.

assumed will apply over the period 1 January to 31 December 2021 for the purpose of our draft decision.

Table B.3 Domestic electricity network charges, 2020 (GST exclusive)

Distribution zone	Daily charge ($ per year)	Variable charge structure	Variable charge ($ per kWh)	Controlled load ($ per kWh)
AusNet Services	$118.00	Block 1 Block 2	$0.1136 $0.1308	$0.0415
CitiPower	$95.00	Anytime	$0.0706	$0.0223
Jemena	$59.18	Anytime	$0.0858	$0.0257
Powercor	$140.00	Anytime	$0.0798	$0.0256
United Energy	$47.19	Anytime	$0.0949	$0.0223

Source: Victorian distribution businesses' 2020 annual tariff statements

Table B.4 Small business electricity network charges, 2020 (GST exclusive)

Distribution zone	Daily charge ($ per year)	Variable charge structure	Variable charge ($ per kWh)
AusNet Services	$118.00	Block 1 Block 2	$0.1519 $0.1852
CitiPower	$160.00	Anytime	$0.0864
Jemena	$102.51	Anytime	$0.1078
Powercor	$180.00	Anytime	$0.0875
United Energy	$66.83	Anytime	$0.1125

Source: Victorian distribution businesses' 2020 annual tariff statements

The AER is aiming to make its final determination on the Victorian network businesses regulatory proposals for the regulatory period 1 July 2021 to 30 June 2026 by 30 April 2021 and the network businesses will have to 31 May 2021 to publish their network tariffs that apply from 1 July 2021. Therefore, for the network tariffs that apply from 1 July to 31 December 2021 we have maintained 2020 metering costs for our draft decision.

Table B.5 Network metering charges, 2020 (GST exclusive)

Distribution business	Annual metering charge ($ per customer)
AusNet Services	$51.40
CitiPower	$71.30
Jemena	$79.64
Powercor	$67.30
United Energy	$54.23

Source: Victorian distribution businesses' 2020 annual tariff statements

Environmental scheme costs

Large-scale Renewable Energy Target (LRET) costs

Under the LRET scheme, the liability percentage is called the Renewable Power Percentage. The Clean Energy Regulator will not set the Renewable Power Percentage for 2021 until March 2021. As an alternative the Clean Energy Regulator provides an approach for calculating a default RPP. We have engaged Frontier Economics to estimate the cost of complying with the LRET. This includes estimating the default Renewable Power Percentage for 2021 (18.83 per cent) and calculating the 12-month average of 2020 futures market prices for certificates (LGCs) as reported by Demand Manager.[126] The resulting estimate is reported in table B.6.

Small-scale Renewable Energy Scheme (SRES) costs

The liability percentage under the SRES scheme is called the Small-Scale Technology Percentage (STP). The federal Clean Energy Regulator does not publish the binding STP until March 2021.

126 Available at: http://demandmanager.com.au/certificate-prices. Accessed 21 July 2020.

However, it has published the non-binding STP for 2021 at 19.40 per cent.[127] The actual binding STP for 2020 was set at 24.40 percent.

Historically, spot prices for certificates under the SRES have been at or close to the clearing house price of $40. For this reason, the price per certificate is assumed to be $40.

To set an allowance for SRES costs, we have used the mid-point of the non-binding STP for 2021 and the binding STP for 2020, plus the level of the difference between the forecast STP we used in the 2020 VDO and the actual binding STP for 2020 (6.25 per cent), multiplied by the clearing house price.

The higher level of the non-binding STP the Clean Energy Regulator has set for 2021, along with the 6.25 per cent allowance to account for the difference between the forecast STP used in the 2020 VDO and the actual binding STP for 2020, has increased the allowance for SRES costs in our draft decision compared to the 2020 VDO. This is reflected in an increase in both the residential and small business average annual bills.

Victorian Energy Upgrades costs

For the cost of complying with the Victorian Energy Upgrades scheme, we use the relevant greenhouse reduction rate for electricity of the reference price year being assessed. The greenhouse reduction rate for 2021 has not yet been set so our draft decision uses the rate for the 2020 compliance year of 0.17255. We understand that the 2021 greenhouse reduction rate will be set prior to our final decision, which will be updated to include the 2021 rate. The cost of certificates under the Victorian Energy Upgrades scheme is gathered from historic market prices. Based on currently available information, we estimate an average price of $30.81 per certificate for 2021.

Our estimate of the average price per certificate is around $10 higher than the estimate used to calculate VEU costs for the 2020 VDO. This has increased the allowance for VEU costs in our draft decision compared to the 2020 VDO and is reflected in an increase in both the residential and small business average annual bills.

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[127] Available at http://www.cleanenergyregulator.gov.au/RET/Scheme-participants-and-industry/the-small-scale-technology-percentage. We note that there have historically been significant differences between the non-binding STP and the binding STP which we will account for through a true-up mechanism.

Table B.6 Cost of complying with Environmental Schemes (GST exclusive):

Environmental scheme	Certificate price	Scheme liability	Cost ($/MWh)
LRET	$34.44	18.83%	$6.49
SRES	$40.00	28.15%	$11.26
Victorian Energy Upgrades	$30.81	17.26%	$5.32

Source: Frontier Economics, Wholesale electricity costs for 2021: 27 August 2020, pp 50-52.

Retail operating costs

We have described our benchmarking approach to retail costs and margin in the chapter on VDO cost components. These costs are fixed and apply equally across each distribution zone.

Retail costs

Based on our updated benchmarks, we have selected an allowance of $135.12 for retail operating costs and $37.87 for customer acquisition and retention costs (see table B.7).

Retail margin

We propose to apply a retail margin of 5.7 per cent. The retail margin represents the margin in dollars as a proportion of the total revenue.

Table B.7 Retail costs and margin (GST exclusive)

Retail costs and margin	Annual allowance
Retail operating costs	$135.12
Customer acquisition and retention costs	$37.87
Retail margin	5.7%

Other costs

Retailers incur other costs through fees for market operations and ancillary services. Information about these costs has been gathered primarily from AEMO's Budget and Fees report.[128] The estimate of our licence fee is a market-wide average based on the approved fees for the year 2018-19, updated for inflation.[129] We have adopted a forecast of ancillary charges based on analysis of the past 12 months of ancillary service cost data. The impact of the social cost of carbon on retailer costs is based on total small-scale renewable exports in 2019-20 and customer numbers in 2018-19.

Table B.8 Other costs (GST exclusive)

Charge	Rate
AEMO fees	
NEM market fees	$0.37/MWh
Full retail contestability	$1.33/customer
National Transmission Planner	$0.00/MWh
Energy Consumers Australia	$0.62/customer
Ancillary services	$0.42/MWh
RERT	$2.43/customer
ESC licence fee	$0.97/customer
Feed-in Tariff (social cost of carbon)	$10.90/customer
Total per MWh $0.79/MWh	
Total per customer $16.24/customer	

[128] Australian Energy Market Operator, 2020-21 AEMO Final Budget and Fees.

[129] Our final decision will be updated with newer data if it is available.

Appendix C: Our legislative considerations

The pricing order provides the commission’s power to make a VDO price determination and imposes some constraints on that power. This chapter explains at a high level the requirements for, and matters we must have regard to in, making the determination.

The commission's statutory power to determine the VDO

In making a VDO price determination we must adopt an approach and methodology that is in accordance with section 33(2) of the *Essential Services Commission Act 2001 (Vic)* (ESC Act), and the pricing order.[130] Taken together, this means we must adopt an approach and methodology that best meets the objectives specified in the ESC Act, the commission’s objectives under the *Electricity Industry Act 2000 (Vic)* (EI Act) and the objective of the VDO.[131]

Further, the VDO price determination must be based on the efficient costs of the sale of electricity by a retailer,[132] having regard to:[133]

- wholesale electricity costs
- network costs
- environmental costs
- retail operating costs, including only modest costs of customer acquisition and retention[134]
- retail operating margin[135]
- any other costs, matters or things we consider appropriate or relevant.

The pricing order also specifies that we must not include headroom.[136]

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[130] Clause 12(1) of the pricing order.

[131] Best meeting the objective of the VDO is a requirement of clause 12(2) of the pricing order.

[132] Clause 12(3) of the order. Further, clause 12(8) affirms that the pricing order does not require the commission to determine tariffs based on the actual costs of a retailer.

[133] Clause 12(4) of the pricing order.

[134] Clause 12(6) of the pricing order specifies that this is to be an amount determined by the commission in its discretion.

[135] Clause 12(7) of the pricing order specifies that this is to be an amount determined by the commission in its discretion, and in doing so regard must be had to (without limitation) the principle that the margin must not compensate retailers for risks that are compensated elsewhere in the costs. Clause 12(9) of the pricing order affirms that the commission is not required to determine tariffs based on the actual retail operating margin of a retailer.

[136] Clause 12(10) of the pricing order; 'headroom' being defined in clause 4(1) as ‘an allowance that does not reflect an efficient cost borne by firms operating in the market.’

Our objectives in setting the VDO

As specified in the pricing order, the objective of the VDO is to provide a simple, trusted and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the electricity retail market.[137]

The objective of the commission under the ESC Act is to promote the long-term interests of Victorian consumers, having regard to the price, quality and reliability of essential services. As objectives of the EI Act, the commission must adopt an approach which promotes protections for customers, the development of full retail competition and a consistent regulatory approach between the electricity and gas industries (noting there is currently no framework for the regulation of prices for retail gas services).

Without derogating from these objectives and the matters to which regard must be had under section 8A of the ESC Act outlined below, the commission must also when performing its functions and exercising its powers do so in a manner that the commission considers best achieves any objectives specified in the empowering instrument, in this case the pricing order.

In making a price determination, the commission must adopt an approach and methodology which the commission considers will best meet the objectives specified in the ESC Act and any relevant legislation. Section 33(5) of the ESC Act further states that a price determination by the commission may regulate a prescribed price for prescribed goods and services in any manner the commission considers appropriate.

Other factors the commission must have regard to

Section 8A of the ESC Act provides that in seeking to achieve the commission's objective to promote the long-term interests of Victorian consumers, the commission must have regard to the following matters to the extent that they are relevant in any particular case:

- efficiency in the industry and incentives for long term investment;
- the financial viability of the industry;
- the degree of, and scope for, competition within the industry, including countervailing market power and information asymmetries;
- the relevant health, safety, environmental and social legislation applying to the industry;
- the benefits and costs of regulation (including externalities and the gains from competition and efficiency) for consumers and users of products or services (including low income and vulnerable consumers) and regulated entities;

[137] Clause 3 of the order sets out the objective of the VDO.

- consistency in regulation between States and on a national basis;
- any matters specified in the empowering instrument (i.e. the pricing order; see discussion above).

Section 33 of the ESC Act only applies to the extent it is not contrary to the pricing order.[138] Section 33(2) of the ESC Act provides that in making a price determination, the commission must adopt an approach and methodology which the commission considers will best meet the objectives specified in the ESC Act and the EI Act.[139]

Section 33(3) of the ESC Act specifies some methodological considerations, specifically:

- the particular circumstances of the regulated industry (i.e. retail electricity market) and the prescribed goods and services (i.e. standing offers) for which the determination is being made;
- the efficient costs of producing or supplying regulated goods or services and of complying with relevant legislation and relevant health, safety, environmental and social legislation applying to the regulated industry;
- the return on assets in the regulated industry;
- any relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries;
- any other factors that the commission considers relevant.

In addition, section 33(4)(b) of the ESC Act provides that in making a determination, the commission must ensure that the determination takes into account and clearly articulates any trade-offs between costs and service standards.[140]

[138] Clause 12(12) of the order.

[139] Section 33(2) of the ESC Act. The section refers to 'relevant legislation', which in this circumstance means the EI Act.

[140] Under clause 12(11) of the pricing order, section 33(4)(a) does not apply to a VDO determination.

Appendix D: How we have assessed the VDO

Appendix C sets out the requirements and matters we must have regard to in making a Victorian Default Offer (VDO) price determination. This chapter summarises, how we have considered these matters.

Our approach to this review

In coming to our draft decision on the VDO, we have built on our 2020 VDO price determination, assessed developments in the retail electricity market (since we made our last determination) and analysed the costs of providing retail electricity services, among other matters. We consider this approach and methodology best meets our legislative objectives and requirements.

Our review used largely the same methodology as we did in our 2020 VDO price determination. As part of this review, the estimates included in the VDO cost stack have been updated to reflect changes in the market and new data that is now available. Our approach helped us establish the cost estimates that best meet our legislative objectives, including our obligation that the VDO price determination be based on the efficient costs of the sale of electricity by a retailer, in light of the matters we must have regard to (see appendix C).

We analysed the efficient costs of electricity retailers

Through information requests, and issuing notices under our compulsory information gathering powers, we collected cost data from electricity retailers. This information allowed us to understand the types of costs electricity retailers incur and elements of the efficient costs of supplying electricity to customers. We sought advice from independent consultants on forecasting of retailers' wholesale electricity costs and of retailers' costs of complying with environmental programs for calendar year 2021.

Our approach and methodology included the elements listed below to estimate the efficient costs of the sale of electricity by a retailer.[141] This includes:

- **wholesale electricity costs –** based on the expected future electricity costs in the market, which also includes the cost of electricity lost when it is transported
- **network costs** – which will be directly taken from tariffs approved by the Australian Energy Regulator

[141] Clause 12(4) of the order.

- **environmental costs** – using available market data on the expected future costs of meeting renewable energy schemes and the Victorian Energy Upgrades program
- **retail operating costs** – based on benchmarks from previous regulatory decisions
- **other costs** – taken directly from published reports from industry bodies
- **retail operating margin** – based on a benchmark from a comparable regulatory decision.

Some elements of the cost-stack are estimated using market data such as wholesale electricity purchase costs. We intend to update estimates of these elements for our final decision and VDO price determination to account for any changes in market data. The data provided by retailers was used as a cross check of our VDO cost stack and allowed us to compare the cost stack elements across different segments of the retail market. We also used findings from other regulators (such as the Australian Competition and Consumer Commission's Retail Electricity Pricing Inquiry final report) in assessing the cost stack.

We note that the VDO allowance amounts may differ from the actual costs of retailers. This is because we have sought to estimate the efficient costs of retailers. In addition, as required by the pricing order, we have not included headroom in our cost stack.

We considered the impact of the coronavirus pandemic and other changes

In considering efficient costs, we may consider any other costs additional to those identified in the pricing order, or other matters or things we, in the exercise of our discretion, consider appropriate or relevant.[142]

Among other things, our review has taken into consideration the impact of the coronavirus pandemic (the pandemic) on retailers and the retail electricity market. When considering these impacts, our consultation paper stated we would explore where there have been permanent changes to efficient costs across the industry rather than temporary changes. As part of this determination we have considered the need to allow for variation and flexibility where justified, having regard to our statutory objectives including promoting stability, certainty and trust in a regulatory approach.

Through stakeholder submissions we heard many Victorian residential and small business customers are experiencing vulnerability because of the pandemic, including payment difficulties. There have also been changes in the regulatory framework to support customers and retailers during this time. We have considered the information available and sought advice on the impact on the retail electricity market. In considering this information we have had regard to our statutory

[142] Clause 12(4)(f) of the order.

objectives, including the financial viability of the retail energy market and promoting full retail competition.

We also had regard to other changes in the regulatory environment that may affect retailers' efficient costs.

- The AEMO published a final determination and rule which delays the commencement of five-minute settlements by three months, so that they commence on 1 October 2021.
- We are also aware that the Retailer Reliability Obligation commenced on 1 July 2019 and is ongoing. At this time, given the Retailer Reliability Obligation has not been triggered there are no material costs for us to consider as part of this review. We note changes beyond this period are outside the scope of our review.

We considered our approach to the compliant maximum annual bill

Our price determination framework also includes a VDO compliant maximum annual bill. While our first determination was required to use a maximum bill to regulate non-flat standing offer tariffs, the requirements for subsequent decisions (including this one) allow us to decide on the best approach. In proposing a compliant maximum annual bill in this draft decision, we have had regard to the objective of the VDO to be a simple option and sought to provide for a framework that has regard to administrative costs of retailers and ease of understanding by customers.[143] As with other elements of our methodology, we have also had regard to the approaches adopted by other regulators including the AER's Default Market Offer.[144]

Our assessment approach helps us meet our legislative requirements

Our assessment approach helps us meet our objectives

In setting the VDO our objectives are to:

- provide a simple, trusted and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the electricity retail market.[145]
- promote the long-term interests of Victorian consumers. In seeking to achieve this objective we must have regard to the price, quality and reliability of essential services. [146]

[143] Section 8A(1)(e) of the ESC Act and section 10(c) of the EI Act.

[144] Section 8A(1)(f) of the ESC Act.

[145] Clauses 3 and 12(2) of the pricing order. Also consistent with section 10(c), EI Act.

[146] Section 8 of the ESC Act

In terms of promoting the development of full retail competition, the VDO does not prevent customers from choosing their electricity retailer. As retailers will still be free to compete for customers in the market by making offers above and below the VDO, we note that our approach to the VDO is consistent with the objective in the EI Act relating to full retail competition.

Having regard to the relevant matters under the ESC Act

In making our determination, we must have regard to a number of matters to the extent that they are relevant.[147] We have had regard to all of these matters in coming to our draft decision.

Efficiency

Efficiency is an important consideration for our decision.[148] Our approach helped us establish the tariffs that reflect the efficient costs of the sale of electricity by a retailer: , including an allowance for the retail operating margin.[149] Our review used largely the same approach as our 2020 VDO price determination.

Financial viability

A related matter is the consideration of long-term incentives for investment and financial viability.[150] As our draft decision on the VDO reflects our estimates of efficient costs we consider that it helps promote the financial viability of the industry.

Competition within the industry

In relation to scope for competition in the market we note setting prices at efficient costs is consistent with competition and does not preclude innovation that may lead to customers accepting market contracts that offer a better deal for them than the VDO. Likewise, it does not prevent retailers, who can lower their costs, from attracting customers by making cheaper market offers available.[151]

In our consideration of the retail margin we also considered the range and types of offers available to customers as part of our review. This showed that the median priced market offer retailers provide is still cheaper than the VDO.

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[147] Sections 8A and 33(3) of the ESC Act.

[148] Section 8A(1)(a) and 33(3)(b) of the ESC Act 2001.

[149] Section 33(3)(c) of the ESC Act; clause 12(4)(e) of the order.

[150] Section 8A(1)(b) of the ESC Act.

[151] Section 8A(1)(c) of the ESC Act.

The relevant legislation applying to the industry

We considered other legislation that affects the efficient costs of a retailer[152] Among, other things, we considered costs associated with regulatory requirements on retailers (such as the LRET, SRES and five-minute settlements). We also note that our benchmarks of retailer operating costs, CARC and retail operating margin reflect the costs and margins of Australian retailers complying with the regulatory and legislative requirements.

The benefits and costs of regulation

The VDO was introduced as part of an independent review of the gas and electricity markets in Victoria. The VDO is a simple, trusted and reasonably priced electricity option that safeguards customers unable to engage in the electricity retail market.[153] In formulating the VDO we are not required to revisit the costs and benefits of implementing the VDO.[154]

We have, however, had regard to the costs and benefits of regulation in our approach to formulating the VDO.[155] The VDO reflects a price that is based on the efficient costs of providing retail electricity services. The efficient cost and its interrelationship with the costs and benefits of regulation have been considered throughout our decision. Further, in consulting with stakeholders, we considered the information presented to us and noted we would require strong new evidence to change our approach for most cost items. In using this already established approach we sought to minimise the amount of change and regulatory burden for stakeholders.

Consistency in regulation between States and on a national basis and any relevant interstate and international benchmarks in comparable industries:

We looked at regulation of retail electricity prices on a national basis and considered relevant benchmarks from State jurisdictions. In considering the national pricing regulation (Default Market Offer) we also had regard to the different policy intent of the relevant legislation.[156]

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[152] Section 8A(1)(d) of the ESC Act.

[153] The development of the VDO stemmed from the Independent Review into the Electricity and Gas Retail Markets in Victoria. The final report from the Independent Review recommended a range of regulatory responses were required to protect the long-term interests of consumers. See Independent Review into the Electricity and Gas Retail Markets in Victoria: Final Report, August 2017, p. 52.

[154] Under clause 12(11) of the pricing order, section 33(4)(a) does not apply to a VDO determination.

[155] Section 8A(1)(e) of the ESC Act.

[156] Section 8A(1)(f) and 33(3)(d) of the ESC Act.

The particular circumstances of the regulated industry

As part of this review, the estimates included in the VDO cost stack have been updated to reflect changes in the market and new data that is now available.[157] We also had regard to actual cost data from retailers. We also considered the broader economic environment including the impact of the pandemic on retailers' costs. We have also included an additional amount in our benchmarking of retail operating costs to cover differences in regulation between Victoria and other parts of Australia.

Accounting for trade-offs between costs and service standards:

We must ensure that the determination takes into account and clearly articulates any trade-offs between costs and service standards.[158] In terms of quality and reliability of services, retailers are required to offer the VDO under the regulated terms and conditions for standard retail contracts. We consider the allowance provided to retailers under the VDO will be sufficient for retailers to ensure the quality of service experienced by customers to at least continue to meet these regulated terms and conditions.

Having regard to the other relevant matters the pricing order

Clause 12 of the pricing order provides guidance on the approach and methodology for making a VDO price determination.[159] We have considered this guidance in making our decision. The relevant matters are considered in the body of our decision including the VDO cost stack chapter, chapter on flat tariffs and maximum bill, and earlier in this appendix.

[157] Section 8A(1)(e) of the ESC Act.

[158] Section 33(4)(b) of the ESC Act.

[159] Clause 12 of the order.

Appendix E: Submissions on the consultation paper

Name of organisation	Date received
Anonymous 1	16 June 2020
Anonymous 2	16 June 2020
Anonymous 3	17 June 2020
Ronald Heard	17 June 2020
Quentin O’Keefe	18 June 2020
Robert Baird	23 June 2020
Linda Oliveira	24 June 2020
Anonymous 4	27 June 2020
Anonymous 5	5 July 2020
Anonymous 6	18 July 2020
Tango Energy	20 July 2020
AGL	21 July 2020
Alinta Energy	21 July 2020
amaysim	21 July 2020
Australian Energy Council	21 July 2020
Consumer Action Law Centre	21 July 2020
Elysian Energy	21 July 2020

EnergyAustralia	21 July 2020
Globird Energy	21 July 2020
Momentum Energy	21 July 2020
Origin Energy	21 July 2020
Powershop and MEA Group	21 July 2020
Red Energy and Lumo Energy	21 July 2020
Simply Energy	21 July 2020
Victorian Council of Social Service	21 July 2020
Next Business Energy	30 July 2020

Appendix F: Pricing order

Victorian Government Gazette

No. S 208 Thursday 30 May 2019

By Authority of Victorian Government Printer

The Lieutenant-Governor, as the Governor's deputy, with the advice of the Executive Council on the recommendation of the Minister pursuant to section 13(1B) of the **Electricity Industry Act 2000** (the Minister having first consulted with the Premier and Treasurer pursuant to section 13(1C) of that Act), acting under section 13 of the **Electricity Industry Act 2000** makes the following Order:

1. Purpose

The main purpose of this Order is to regulate the standing offer tariffs that retailers may charge prescribed customers, through the introduction of the Victorian default offer.

2. Commencement

This Order comes into operation on the date on which it is published in the Government Gazette and remains in force until it is revoked.

3. Objective of the Victorian default offer

The objective of the Victorian default offer is to provide a simple, trusted and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the electricity retail market.

4. Definitions

1. In this Order:

Act means the **Electricity Industry Act 2000**;

annual reference consumption has the meaning given in clause 15(5);

controlled load tariff means a tariff for the supply or sale of electricity only for use in specific appliances that are permanently wired to the relevant electricity meter;

Example: A storage water heater is such an appliance.

controlled load usage means use by a specific appliance that is permanently wired to the relevant electricity meter;

customer type means a customer who is either a domestic customer or a small business customer, as the case may be;

distribution system means a system of electric lines and associated equipment (generally at nominal voltage levels of 66 kV or below) which a distribution company is licensed to use to distribute electricity for supply under its licence;

distribution zone means the area in which a distribution company is licensed to distribute and supply electricity under the Act;

domestic customer means a customer who purchases electricity principally for personal, household or domestic use at a supply point;

Energy Retail Code means the document of that name (version 12 dated 1 January 2019) published by the Commission as amended and in force from time to time;

ESC Act means the **Essential Services Commission Act 2001**;

flat tariff means a tariff for the supply or sale of electricity where the tariff components do not vary by reference to:

(a) the time of day;

(b) the amount of electricity distributed or supplied during the day;

(c) temperature, whether actual or forecast; or

(d) other characteristics that vary during the day.

Notes:

1. A tariff with a daily supply charge as one tariff component and a usage charge calculated by $ per kWh as another tariff component, is a flat tariff;
2. Paragraph (b) does not exclude block tariffs from being flat tariffs;
3. The definition does not exclude tariffs that vary seasonally, from being flat tariffs;

flexible tariff means a tariff for the supply or sale of electricity where the tariff components vary (wholly or partly) according to the time of day when the electricity is supplied;

former franchise customer means a person described in section 37 of the Act who is either a domestic customer or a small business customer;

general usage means any electricity usage that is not controlled load usage;

headroom means an allowance that does not reflect an efficient cost borne by firms operating in the market;

Example: An allowance that is added, so that retail prices do not act as a barrier to new entrants, is headroom.

kWh means kilowatt hour;

Minister means the Minister administering the Act;

MWh means megawatt hour;

objective of the Victorian default offer means the objective specified in clause 3;

Order means this Order;

prescribed customer: see clause 5;

quarter means a period of 3 consecutive months;

regulatory period means a period over which a VDO price determination is to apply;

Note: the first regulatory period commences on 1 January 2020.

relevant customer has the same meaning as in section 39 of the Act;

small business customer means a customer who is not a domestic customer and whose aggregate consumption of electricity taken from a supply point is not, or in the case of a new supply point is not likely to be, more than 40 MWh per annum;

standing offer tariffs means the tariffs determined by a licensee under section 35(1) of the Act and published in the Government Gazette in accordance with that section, as varied from time to time by the licensee as provided for under section 35(3) of the Act;

supply charge means a fixed charge for supplying electricity to a customer (whether charged on a daily basis or over any other period);

Note: A supply charge is also sometimes called a service charge.

supply point means, in relation to a supply of electricity to a person, the point at which that supply of electricity last leaves the distribution system owned or operated by a distribution company before being supplied to the person, whether or not the electricity passes through facilities owned or operated by any other person after leaving that point before being so supplied;

tariff component, in respect of a tariff for the supply or sale of electricity, includes the supply charge, the usage charge and any other charge that is part of the tariff for the supply or sale of electricity;

usage charge means a charge for the amount of electricity supplied or sold to a customer;

Note: A usage charge is sometimes called a consumption charge.

VDO compliant maximum annual bill has the meaning given it in clause 10(2);

VDO price determination means a price determination pursuant to clause 10;

Victorian default offer or ***VDO*** means an offer a retailer must make pursuant to this Order.

2. Despite subclause (1), in:

(a) clause 6;

(b) clause 7;

(c) clause 10(2)(a)(i),

(d) schedule 1; and

(e) schedule 2,

the following definitions instead apply:

(f) ***domestic customer*** means a domestic customer within the meaning of the definition of 'domestic or small business customer' in the Act; and

(g) ***small business customer*** means a small business customer within the meaning of that definition.

Notes:

1. The following terms are defined in section 3 of the Act: Commission;
domestic or small business customer; distribution
company;
electricity bill;
regulated tariff standing offer; retailer;
standing offer.

2. As at the date of the commencement of this Order, the Order in Council made under section 35 of the Act and published in the Government Gazette No. S 315 on 25 November 2008 applies for the purposes of the definition of 'domestic or small business customer' in the Act.

3. 'price determination' is defined in section 13(6) of the Act.

5. Declaration of Prescribed customers

The following customers are declared, pursuant to section 13(5) of the Act, to be prescribed customers:

(a) a domestic or small business customer;

(b) a former franchise customer who is a party to a deemed contract under section 37 of the Act; and

(c) a relevant customer who is a party to a deemed contract under section 39 of the Act.

6. Victorian default offer tariffs

1. A retailer's standing offer tariffs for sale of electricity to prescribed customers must comply with this clause.

2. During the period from 1 July 2019 to 31 December 2019, the standing offer tariffs a retailer may charge to a domestic customer, in respect of the distribution zone specified in column 1 of the table in Schedule 1, are fixed at the amounts specified in columns 2, 4 and 5 of the table for the tariff components specified in those columns.

3. During the period from 1 July 2019 to 31 December 2019, the standing offer tariffs a retailer may charge to a small business customer, in respect of the distribution zone specified in column 1 of the table in Schedule 2, are fixed at the amounts specified in columns 2 and 4 of the table for the tariff components specified in those columns.

4. Subclauses (2) and (3) do not apply to standing offer tariffs other than:

(a) a flat tariff; or

(b) a flat tariff with a controlled load tariff.

5. During any regulatory period commencing on or after 1 January 2020, a retailer's standing offer tariffs for sale of electricity to prescribed customers must comply with any VDO price determination made by the Commission that is in force.

Note: The VDO price determination will be in respect of both standing offer tariffs that are flat tariffs and standing offer tariffs that are not flat tariffs. See also clause 10.

7. Retailer must make Victorian default offer

1. A retailer's regulated tariff standing offer for sale of electricity to prescribed customers must include (specified as the '*Victorian default offer in respect of flat tariffs*'):

(a) one flat tariff that is available to each domestic customer;

(b) one flat tariff with a controlled load tariff that is available to each domestic customer with a controlled load; and

(c) one flat tariff that is available to each small business customer, which tariffs must be:

(d) for the period from 1 July 2019 to 31 December 2019, those fixed in accordance with clause 6(2) and clause 6(3);

(e) for any regulatory period commencing on or after 1 January 2020, standing offer tariffs complying with the VDO price determination in respect of that regulatory period.

2. In addition, for any regulatory period commencing on or after 1 January 2020 and in the case of standing offer tariffs that:

(a) are not flat tariffs; or

(b) are any combination of a flat tariff, and a tariff that is not a flat tariff,

a retailer's regulated tariff standing offer must include standing offer tariffs and terms and conditions (both specified as the '*Victorian default offer in respect of the VDO compliant maximum annual bill*') that ensure the retailer's compliance with the VDO price determination in respect of that regulatory period.

8. Information about the VDO on electricity bills

1. This clause applies until such time as the amendments to the Energy Retail Code required by clause 16(2)(b) come into force.

2. A retailer's electricity bill issued to a prescribed customer on or after 1 October 2019 must include information about how the customer may access the Victorian default offer from the retailer.

3. The information required by subclause (2) must be in plain and clear English and prominent on the electricity bill.

9. Conferral of functions and powers on the Commission

1. For the purposes of Part 3 of the ESC Act and section 12(1)(b) of the Act, the supply or sale of electricity under the Act is specified as prescribed goods and services in respect of which the Commission has the power to regulate prices.

2. The Commission may not make a price determination regulating tariffs for the supply or sale of electricity under the Act except as contemplated under this Order.

Note: See section 32 in Part 3 of the ESC Act. This Order is an empowering instrument for the purposes of Part 3 of the ESC Act: see paragraph (d) of the definition of 'empowering instrument' in section 3 of the ESC Act.

10. Commission to make VDO price determination

1. At least 37 days before the commencement of a regulatory period, the Commission must make a price determination in respect of the regulatory period that determines, for each distribution zone in Victoria:

(a) the tariffs, or the maximum tariffs, a retailer may charge prescribed customers under a standing offer during the regulatory period; or

(b) the manner in which the tariffs, or the maximum tariffs, a retailer may charge prescribed customers under a standing offer during the regulatory period are to be determined or calculated.

2. Without limiting subclause (1), the price determination that the Commission makes in respect of the first regulatory period:

(a) must determine:

i. the standing offer tariffs that are to apply in respect of flat tariffs, including, in the case of domestic customers, both flat tariffs and flat tariffs with a controlled load tariff; and

ii. in the case of a prescribed customer who is on:

A. a tariff that is not a flat tariff; or

B. any combination of a flat tariff, and a tariff that is not a flat tariff,

the maximum annual electricity bill amount that the prescribed customer is to pay under a standing offer in the regulatory period (***VDO compliant maximum annual bill***); and

(b) may provide, in the case of the customers specified in subclause (2)(a)(ii), for how any overpayment by those customers in that regulatory period, or any year (or part year) thereof, is to be dealt with; and

(c) may also include any other decisions or determinations that are required by this Order.

3. Despite subclause (2), the Commission may after its first price determination, determine another manner pursuant to which the standing offer tariffs referred to in that subclause are to be determined or calculated.

11. Regulatory periods for VDO price determinations

1. The first regulatory period commences on 1 January 2020.
2. Subject to subclause (3), the duration of each regulatory period is 12 months.
3. Before the commencement of a regulatory period, if the Commission considers that special circumstances exist, the Commission may, after consulting the Minister:
   (a) extend the duration of the regulatory period by up to 6 months; or
   (b) reduce the duration of the regulatory period, provided the duration of the regulatory period as so reduced is not less than 6 months.

12. Approach and methodology for making a VDO price determination

1. In making a VDO price determination, the Commission must adopt an approach and methodology that is in accordance with section 33(2) of the ESC Act and this Order.

   Note: section 33(2) of the ESC Act requires the Commission to adopt an approach and methodology that best meets the objectives of the ESC Act and of the **Electricity Industry Act 2000.**
2. In addition, the Commission must adopt an approach and methodology which the Commission considers will best meet the objective of the Victorian default offer.
3. The tariffs determined by the Commission pursuant to the VDO price determination are to be based on the efficient costs of the sale of electricity by a retailer.
4. For the purposes of subclause (3), the Commission must have regard to:
   (a) wholesale electricity costs;
   (b) network costs;
   (c) environmental costs;

   retail operating costs, including modest costs of customer acquisition and retention;
   (d) retail operating margin; and
   (e) subject to subclause (10), any other costs, matters or things the Commission, in the exercise of its discretion, considers appropriate or relevant.

   Note: Section 33(3)(e) of the ESC Act similarly requires the Commission to have regard to any other factors that it considers relevant.
5. The VDO compliant maximum annual bill must be based on:
   (a) the standing offer tariffs that the Commission determines are to apply in respect of flat tariffs; and
   (b) the prescribed customer's electricity usage.
6. For the purposes of subclause (4)(d), the Commission must, in the exercise of its discretion, determine the amount of modest costs of customer acquisition and retention.
7. For the purposes of subclause (4)(e), the Commission must, in the exercise of its discretion, determine a maximum retail operating margin, and in doing so must have regard to (without limitation) the principle that the margin must not compensate retailers for risks that are compensated elsewhere in the costs.
8. Subclauses (3), (4), (5) and (6) do not require the Commission to determine tariffs based on the actual costs of a retailer.
9. Subclause (7) does not require the Commission to determine tariffs based on the actual retail operating margin of a retailer.
10. In making a VDO price determination the Commission must not include headroom.
11. Section 33(4)(a) of the ESC Act does not apply to the making of a VDO price determination.
12. Otherwise, section 33 of the ESC Act applies to the making of a VDO price determination only to the extent that the section is not contrary to this Order.

    Notes:

    1. This Order, as an 'empowering instrument' in terms of the ESC Act, can modify the application of section 33 of the ESC Act: see section 33(1) of the ESC Act.
    2. Pursuant to section 33(3)(d) of the ESC Act, the Commission must have regard to relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries.

13. Variation of VDO price determinations

1. Before or during a regulatory period, the Commission may, on its own initiative, vary a VDO price determination in respect of the regulatory period.
2. The Commission must specify, in a VDO price determination, the circumstances under which the Commission will consider, and the basis on which the Commission will decide on, a proposed variation and (subject to subclauses (4) and (5)) the processes to be followed to enable the Commission to make such a variation.

3. Without limiting subclause (1), the Commission may vary a VDO price determination:

(a) if an event has occurred or will occur that was uncertain or unforeseen by the Commission at the time of making the VDO price determination; or

(b) to correct a clerical error, miscalculation, misdescription or other deficiency.

4. Before making a variation, the Commission must consult in accordance with clause 14.

5. Subclause (4) does not apply if:

(a) the variation is not sufficiently material to warrant consultation in accordance with clause 14; or

(a) the need for the variation is sufficiently urgent to warrant consultation in accordance with clause 14 not being undertaken.

6. If, as a result of a variation of a VDO price determination, a retailer is or will be required to vary the retailer's standing offer tariffs, the Commission must ensure the retailer is given adequate notice before the variation to the VDO price determination takes effect.

14. **Consultation**

1. The Commission may decide the nature and extent of stakeholder consultation it will undertake when making a VDO price determination or a decision to vary a VDO price determination.

2. For the purposes of subclause (1), the Commission must have regard to its Charter of Consultation and Regulatory Practice (as amended from time to time) developed and published under section 14 of the ESC Act.

15. **Victorian default offer tariffs to be the reference tariffs for discounts**

1. This clause applies until such time as the amendments to the Energy Retail Code required by clause 16(2)(a) come into force.

   Provided that, if those amendments do not provide for any matter provided for in this clause, then this clause continues to apply in respect of that matter.

2. A retailer that offers a discount to a domestic customer or a small business customer must:

(a) if the discount is in respect of the period from 1 July 2019 to 31 December 2019, disclose how the discount is calculated as against the tariffs in Schedule 1 or Schedule 2 (as the case may be), and what (in percentage or dollar terms) the reduction in tariff is in terms of those tariffs; and

(b) if the discount is in respect of a regulatory period, disclose how the discount is calculated as against the flat tariffs determined by the Commission pursuant to the VDO price determination that applies in respect of that period, and what (in percentage or dollar terms) the reduction in tariffs is in terms of those tariffs.

3. For the purposes of subclause (2), the reduction in tariffs is to be expressed as the difference between the estimated annual cost of the Victorian default offer for the customer type and distribution zone, and the estimated annual cost of the offer to which the discount relates after the discount is applied, using the annual reference consumption.

4. For the purposes of subclause (3):

(a) the estimated annual cost of the Victorian default offer is:

i. during the period from 1 July 2019 to 31 December 2019, determined by applying Schedule 3;

ii. during a regulatory period, determined by applying Schedule 3 or any other approach or methodology determined by the Commission; and

(b) the retailer must determine the estimated annual cost of the retailer's offer to which the discount relates:

i. if the tariff is a flat tariff or a flexible tariff (in either case, with or without a controlled load), by applying Schedule 3;

ii. otherwise, based on a reasonable estimate having regard to any relevant information available to the retailer; and

5. The annual reference consumption is:

(a) during the period from 1 July 2019 to 31 December 2019:

i. for domestic customers without a controlled load – 4,000 kWh general usage per annum;

ii. for domestic customers with a controlled load – 4,000 kWh general usage plus 2,000 kWh controlled load usage per annum;

iii. for small business customers (with or without a controlled load) – 20,000 kWh general usage per annum.

(b) during a regulatory period:

i. the consumption amount determined by the Commission (if any); or

ii. if no amount is determined by the Commission pursuant to subclause (5)(b)(i), the amount specified in subclause (5)(a).

6. For the purposes of subclause (5), the amount of electricity consumed is assumed to be the same on each day of the year.

7. Any percentage or dollar amount disclosed pursuant to this clause must be expressed as a whole percentage or dollar, rounded to the nearest percentage or dollar.

8. Otherwise, Division 2 of Part 2A (*Customers entitled to clear advice*) of the Energy Retail Code applies to the disclosures required by this clause.

16. **Direction to the Commission pursuant to section 13(3)(b) of the Act**

1. The Commission must, as soon as practicable after the commencement of this Order, amend the Energy Retail Code and any other instrument of the Commission to give effect to the Victorian default offer and this Order.

2. Without limiting subclause (1), the Commission must amend the Energy Retail Code (and any other instrument of the Commission) so that the Code:

(a) provides for tariffs determined by the Commission pursuant to the VDO price determination being the reference tariffs for discounts and for the methodology of that comparison; and

(b) requires a retailer's electricity bill to include information about how the customer may access the Victorian default offer from the retailer.

3. For the purposes of subclause (2)(a), the Commission must have regard to the following principles:

(a) There must be a consistent methodology for comparison of tariffs that applies to:

i. all offers of discounts by retailers; and

ii. the advertising in respect of those discounts.

(b) The methodology must apply in respect of flat tariffs and tariffs that are not flat tariffs;

(c) The methodology must (without limitation) readily allow, in respect of a regulatory period, a comparison between:

i. the discounted tariffs offered by a retailer; and

ii. the tariffs determined by the Commission pursuant to the VDO price determination in respect of that period; and

4. Any actual comparison in accordance with the methodology must be readily understandable by a prescribed customer. Subclause (3) does not limit:

(a) the matters the Commission may have regard to; or

(b) the matters the Commission may provide for by way of the amendments required by subclause (2).

17. **Review of the operation of this Order**

The Minister must cause a review of the operation and effectiveness of this Order to be undertaken before the third anniversary of the Order coming into operation.

SCHEDULE 1

Victorian default offer tariffs for period from 1 July 2019 to 31 December 2019 – domestic customers

Charges are inclusive of GST.

Distribution zone	**Supply charge ($ per day)**	**Usage charge structure**	**Usage charge (not controlled load) ($ per kWh)**	**Usage charge: controlled load ($ per kWh)**
AusNet Services	$1.1368	Block 1 (up to 1020 kWh during a quarter) Block 2 (> 1020 kWh during a quarter)	$0.2763 $0.3113	$0.2024
CitiPower	$1.1055	Anytime	$0.2325	$0.1809
Jemena	$1.0037	Anytime	$0.2547	$0.1618
Powercor	$1.2333	Anytime	$0.2403	$0.1561
United Energy	$0.9115	Anytime	$0.2620	$0.1873

SCHEDULE 2

Victorian default offer tariffs for period from 1 July 2019 to 31 December 2019 – small business customers

Charges are inclusive of GST.

Distribution zone	**Supply charge ($ per day)**	**Usage charge structure**	**Usage charge ($ per kWh)**
AusNet Services	$1.1368	Block 1 (up to 1020 kWh during a quarter) Block 2 (> 1020 kWh during a quarter)	$0.3154 $0.3605
CitiPower	$1.2972	Anytime	$0.2464
Jemena	$1.1450	Anytime	$0.2682
Powercor	$1.3611	Anytime	$0.2394
United Energy	$0.9691	Anytime	$0.2717

SCHEDULE 3

1. Estimated annual cost for flat tariff offers

The estimated annual cost for an offer for the supply or sale of electricity under a flat tariff is to be calculated as follows:

$$EAC = SC \times 365 + UC \times ARC$$

where:

EAC is the estimated annual cost of the offer;

SC is the supply charge;

UC is the general usage charge; and

ARC is the annual reference consumption for general usage.

2. Estimated annual cost for flexible tariff offers

The estimated annual cost for an offer for the supply or sale of electricity under a flexible tariff is to be calculated as follows:

$$EAC = SC \times 365 + ARC \times UC_P \times UA_P + ARC \times UC_S \times UA_S + ARC \times UC_{OP} \times UA_{OP}$$

where:

EAC is the estimated annual cost of the offer;

SC is the supply charge; and

ARC is the annual reference consumption for general usage;

and where, in respect of the relevant tariff type specified in column 1 of Table 1:

UC_P is the retailer's peak usage charge;

UA_P is the peak usage allocation specified in column 2 of Table 1; UC_S is the retailer's shoulder usage charge;

UAs is the shoulder usage allocation specified in column 3 of Table 1; UC_{OP} is the retailer's off-peak usage charge; and

UA_{OP} is the off-peak usage allocation specified in column 4 of Table 1.

3. Estimated annual cost for offers that include a controlled load tariff

The estimated annual cost for an offer for the supply or sale of electricity that includes a controlled load tariff is to be calculated as follows:

$$EAC = EAC_{GU} + UC_{CL} \times ARC_{CL}$$

where:

EAC is the estimated annual cost of the offer;

EAC_{GU} is the estimated annual cost of the offer for general usage only, calculated in accordance with clause 1 or 2 of this Schedule 3 (as the case may be);

UC_{CL} is the usage charge for controlled load usage; and

ARC_{CL} is the annual reference consumption for controlled load usage.

Table 1 – Usage allocation for flexible tariffs

Tariff type	Peak	Shoulder	Off-peak
Flexible price (3 part time of use)	0.25	0.45	0.30
5-day time of use	0.52	0.00	0.48
7-day time of use (small business customers only)	0.74	0.00	0.26
5-day time of day 9 pm off peak (United Energy distribution zone only)	0.25	0.20	0.55
5-day time of day (United Energy distribution zone only)	0.32	0.20	0.48

Dated 28 May 2019 Responsible Minister

HON. LILY D'AMBROSIO MP
Minister for Energy, Environment and Climate Change

PIETA TAVROU

Clerk of the Executive Council

Electricity Industry Act 2000

MINISTERIAL ORDER UNDER SECTION 35(3B)

I, Lily D'Ambrosio, Minister for Energy, Environment and Climate Change and Minister responsible for administering the **Electricity Industry Act 2000** (the Act), specify, pursuant to sections 35(3B)(a) and 35(3B)(b) of the Act, the following periods within which a licensee may publish a notice under section 35(3) of the Act, and the following dates on which tariffs varied in accordance with section 35(3) of the Act must take effect.

1. Commencement

This Order commences on the date that it is published in the Government Gazette.

2. Periods within which a notice varying licensee standing offers must be published

If, during the period from the date of commencement of this Order until the expiry date of this Order, a licensee proposes to publish a notice under section 35(3) of the Act, varying the tariffs determined by the licensee and published in the Government Gazette under section 35(1) of the Act, the notice may be published during the following periods:

(a) the period commencing on the date this Order commences and ending on 17 June 2019; and

(b) the period commencing on 25 November 2019 and ending on 18 December 2019.

3. Dates on which a variation to a licensee standing offer under clause 2 must take effect

Pursuant to section 35(3B)(b) of the Act, any variation to licensee standing offer tariffs under clause 2 of this Order must take effect on the following dates:

(a) if the variation is under clause 2(a) – on 1 July 2019; and

(b) if the variation is under clause 2(b) – on 1 January 2020.

4. Expiry of this Order

This Order expires on 31 March 2020.

Dated 22 May 2019

HON. LILY D'AMBROSIO MP

Minister for Energy, Environment and Climate Change