

APRIL 2023



VCOSS submission on draft Victorian Default Offer (VDO) tariffs for 2023-24.

VCOSS welcomes the opportunity to provide feedback to the Essential Services Commission (ESC) on its draft decision for the Victorian Default Offer (VDO) tariffs that will apply in 2023-24.

The VDO is a crucial safeguard for household consumers who are unable to engage in detailed comparisons of market offers for an essential service. Uncertain economic times underscore its importance.

In this submission, VCOSS highlights the damaging impact that the currently proposed increase will have on Victorian households.

VCOSS is not convinced an increase of the magnitude proposed by the ESC is justified.

Our submission identifies VDO cost-stack components where VCOSS believes the key assumptions or proposed regulatory choices should be subject to additional stress-testing by the ESC.

Our submission **also** identifies cost-stack components where VCOSS believes the ESC should take another look at the **impact** of the proposed cost increase on consumers – noting that, under the price-setting methodology, for each part of the cost-stack there is a price range. It is VCOSS's view that the ESC should always tend towards the lowest end.

Rising electricity bills add to the cost-of-living crunch

VCOSS represents community service organisations that are on the frontline of the cost-of-living crisis. These organisations tell us that they are experiencing a tsunami of demand from Victorian households that are struggling to absorb mounting costs, including, for example:

- Private rents in Melbourne and regional Victoria increasing by on average 11.8% and 7.2% respectively in 2022¹

¹ Victorian DFFH, *Rental Report* (2022), available online at <https://www.dffh.vic.gov.au/publications/rental-report> (accessed 27 March 2023)

- Basic groceries increasing 9.2% over the 12 months to December 2022²
- Routine indexation of Commonwealth Government income support payments trailing behind Consumer Price Index increases – and falling well-short of the real increase that is required.³
- These households that are seeking help from their energy retailer also represent an increasing share of all energy customers in Victoria: 2.4 per cent of all residential electricity customers and 2.6 per cent of all residential gas customers, up from 2.2 per cent and 2.1 per cent respectively in the previous year.

Their insights have been validated by VCOSS's 'Listening Tour' of Victorian communities. In every suburb and town we visit around the state, people share stories of immense stress and strain caused by the increasing cost of food, rent, medical services and petrol.⁴

These wider cost-of-living stresses are also reflected in the ESC's latest Market Report,⁵ which shows:

- The number of customers getting additional help from their energy retailer each month has increased by 10 per cent for gas and three per cent for electricity in the first half of the past year (i.e. July-December 2022), compared to the monthly average for the year before (2021–22);
- The average arrears of these customers has also increased, by nine per cent for gas and three per cent for electricity;

The rising price of energy has a devastating and compounding impact on low-income households. Electricity and gas bills represent a much higher share of the ongoing living expenses of these households, and their limited financial resources leave them with few options to safely and sustainably reduce their energy demand (i.e. to stay cool in summer and warm in winter). A shocking and unacceptable consequence of higher energy bills and associated heating and cooling costs is ill-health and excess deaths⁶ – all of which can be prevented by making the right policy choices.

VCOSS acknowledges that the ESC has publicly recognised this wider context in relation to preparing the draft decision.

However, it's not enough to simply recognise this context. These household impacts are not just wider background issues – in VCOSS' view they must be

² Australian Bureau of Statistics, Consumer Price Index – December Quarter 2022 (released 25 January 2023), available online at <https://www.abs.gov.au> (accessed 30 March 2023)

³ ACOSS, *Indexation fails to deliver the real increase people need* (3 January 2023), available online at https://www.acoss.org.au/media_release/indexation-fails-to-deliver-the-real-increase-people-need/

⁴ VCOSS, *Voices of Victoria Listening Tour* (2022), p. 14; available online at https://vcoss.org.au/wp-content/uploads/2022/09/Voices-of-Victoria_web.pdf

⁵ ESC, Victorian Energy Market Report – March Update (2023).

⁶ Northwestern Institute for Policy Research, *When Heating Is More Affordable, Fewer People Die* (Policy Brief March 2020); see also VCOSS, *Feeling the Heat* (2021).

critical considerations when applying the VDO methodology.

As we noted in our submission on the consultation paper for this process, the ESC has a statutory obligation under s8A(1)(e)(i) of the *Essential Services Commission Act 2001* (Vic) to have regard to the benefits and costs of its regulatory decisions on low income and vulnerable consumers.

The current VDO framework does not *require* the ESC to use the lowest cost estimate available in every situation, but VCOSS's view is that the ESC should work from that basis. Subsequently, where there is ambiguity about a cost component or a reasonable data range, VCOSS believes the ESC should use the lower estimate, or justify any decision to use a higher figure.

In making these regulatory decisions for Victoria, VCOSS also encourages the ESC to treat with caution any broad analogies with the circumstances and/or consequences of the current UK energy crisis.

The Victorian context is different, in terms of relevant market rules, potential retailer viability risks, and underlying electricity generation. VCOSS encourages the ESC to carefully weigh these risks based on **local** considerations.

Fully stress-test projected wholesale costs

The past 12 months of wholesale market uncertainty clearly drive the projected 95% increase in this key component of the VDO cost-stack.

Estimating these costs using data from publicly-listed financial products on energy futures provides important transparency and predictability in the current VDO methodology.

However, it is important these inputs are fully stress-tested. A great deal hinges on the details of both the design of this methodology, and the timing and quality of key inputs and assumptions.

As noted in Frontier Economics' initial draft report to the ESC on wholesale electricity costs for 2023-24:

In practice, retailers ... do adopt a mix of hedging strategies [not just exchange-traded futures contracts] ... therefore, regulators will, if anything, tend to overstate the costs that retailers will face, or underestimate the risk management that retailers can achieve

From the perspective of the Victorian community sector, and ordinary Victorian households who rely on the energy regulator to set a fair reference price, is it vital the ESC has fully satisfied itself that this dominant wholesale cost component is as lean as possible.

Ongoing discipline on retail operating costs

VCOSS is pleased to see that retailers' lower actual operating costs are to be reflected in VDO prices, particularly given that (prior to the VDO) this cost component had been particularly opaque and had not been driven down by retail competition.

As VCOSS has noted in previous submissions, the burden of proof should lie with retailers to justify their costs, and it is vital that the ESC remain vigilant in maintaining the intent and discipline inherent in the VDO's policy design and implementation methodology.

In preparing its final decision, the ESC should re-visit and address the limitations it noted in the consultation paper in regard to using the general Consumer Price Index (CPI) for adjusting retailers' costs.⁷

Given real increases in wholesale and other costs, VCOSS would be very concerned if the ESC were to continue to apply a raw

CPI figure as a primary annual adjustment measure across retailers' operating costs (and also other cost stack components), when that tool is known to be increasingly inappropriate for this task (i.e. where the main components of CPI growth, food and fuel, are directly hurting households, but do not substantially contribute to retailers' actual efficient costs).

Pare down the profit margin

Given the share and size of the projected growth in wholesale electricity costs, it is entirely appropriate for that cost component to be the focus of this draft decision.

At the same time, however, VCOSS calls on the ESC to revisit its proposed "no change ... but will continue to monitor" approach to the current allowance for retailers' profit margins.

As the draft decision acknowledges, keeping this profit margin at 5.7 per cent means that the dollar value of this component of the cost stack will increase by 31 per cent.⁸

As noted in 2019's joint submission, there is some degree of circularity if regulators continue to rely on each other's decisions in calculating margins.⁹

⁷ ESC, *Victorian Default Offer 2023-24 Consultation Paper* (8 December 2022), pgs. 17-18.

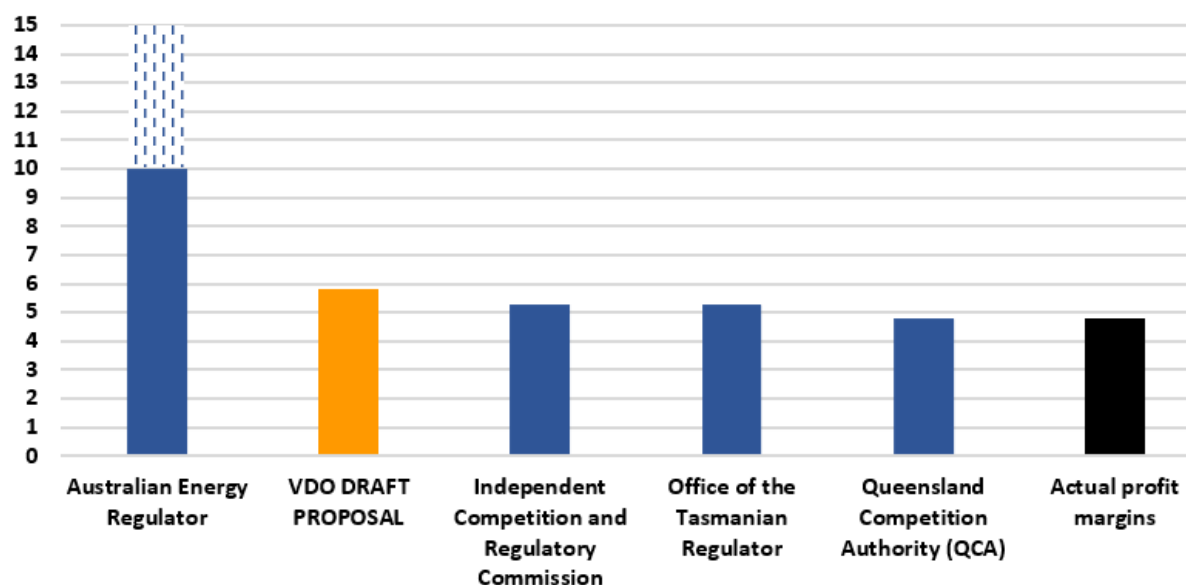
⁸ ESC, *VDO Draft Decision 2023-24*, pg. 41.

⁹ Joint Victorian community sector submission, *Response to the Essential Services Commission draft advice on the*

Victorian Default Offer methodology (April 2019), available online at <https://vcooss.org.au/essential-services/2019/04/fair-energy-outcomes-for-victorians/>

Even based on the equivalent margins cited in the draft decision, however, the current rate is clearly at the upper end. Three of the comparable margins are below the VDO, and the only one above (from the Default Market Offer set by the Australian Energy Regulator) includes other factors (which make it *not* a direct like-for-like comparison). This is illustrated in the table below.

Table 1: Comparable retail operating margins referenced by ESC in the draft decision



Based on cost data, actual profit margins are 4.8 per cent. As VCROSS highlighted at the ESC's public forum on this draft decision: for the major energy retailers these current margins already result in annual profits in the hundreds of millions of dollars last year.

In setting a fair reference price for electricity – a household essential service – it is vital that the VDO puts the needs of people over profit. VCROSS calls on the ESC to revisit the proposed profit margin it allows in the VDO cost-stack, and adopt a significantly lower and more justifiable figure.

To discuss this submission further, please contact Jarrod Lenne,
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VCROSS is the peak body for Victoria's social and community sector, and the state's premier social advocacy body.

We work towards a Victoria free from poverty and disadvantage, where all people and communities experience genuine wellbeing.