

# Victorian Default Offer to apply from 1 January 2020

Issues paper

23 July 2019

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# Overview

From 1 January 2020 the Essential Services Commission will determine prices for standing offers covering electricity retail services in Victoria (the Victorian Default Offer (VDO) prices). This paper follows the framework for regulation of standing offer prices established by the Victorian Government on 30 May 2019 and begins our consultation with stakeholders on the approach to determining these prices. Building on our advice to government on the prices for flat tariff standing offers to apply from 1 July 2019, this issues paper outlines our initial views on the methodology we will use to calculate VDO prices, and the process we will follow in making a determination under this new framework. Finally, we address the interaction between the VDO and embedded network pricing. We invite stakeholders to provide us with feedback to inform our approach.

## Background and context to this issues paper

On 3 May 2019, we provided our final advice to the Victorian Government recommending the flat tariffs to apply to domestic and small business customers (consuming less than 40 megawatt hours (MWh) of electricity per year) for the period 1 July 2019 to 31 December 2019.<sup>1</sup> Our advice was prepared in response to the terms of reference issued by the Victorian Government in December 2018.<sup>2</sup> On 30 May 2019, the Governor in Council published an order<sup>3</sup> prescribing flat standing offer tariffs for domestic and small business customers during the period 1 July 2019 to 31 December 2019 based on our advice to government.

From 1 July 2019, retailers have been required to make flat standing offers available to domestic and small business customers in the form of:<sup>4</sup>

- one flat tariff that is available to each domestic customer
- one flat tariff with a controlled load tariff that is available to each domestic customer with a controlled load, and

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<sup>1</sup> Domestic customer means a customer who purchases electricity principally for personal, household or domestic use, and small business customer means a customer who is not a domestic customer and whose aggregate consumption taken from a supply point is not, or in the case of a new supply point not likely to be, more than 40 MWh per annum.

<sup>2</sup> Fair Pricing in the Energy Market: Terms of Reference for the Essential Services Commission, 21 December 2018, available at: <https://www.esc.vic.gov.au/sites/default/files/documents/retail-market-review-victorian-default-offer-terms-of-reference-20181221.pdf>.

<sup>3</sup> Order 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).

<sup>4</sup> Schedule 1 of the order specifies Victorian Default Offer tariffs for period from 1 July 2019 to 31 December 2019 - domestic customers.

Schedule 2 of the order specifies Victorian Default Offer tariffs for period from 1 July 2019 to 31 December 2019 - small business customers.

- one flat tariff that is available to each small business customer.

For the period 1 July to 31 December 2019, there remain some customers on standing offer tariffs that are not regulated by the order. However, the order does require that during any regulatory period commencing on or after 1 January 2020, all of a retailer's standing offers must comply with a VDO price determination made by the commission.<sup>5</sup>

The order requires that we make a VDO price determination by 25 November 2019 for each distribution zone in Victoria.<sup>6</sup> The first VDO price determination will apply for the first regulatory period from 1 January 2020 to 31 December 2020 for both domestic and small business customers.<sup>7</sup>

As specified in the order, we will determine:

- tariffs that are to apply to flat standing offer tariffs, including flat plus controlled load tariffs for domestic customers (VDO tariffs), and
- the maximum annual electricity bill amount that a customer is to pay under a standing offer that provides for tariffs that are not flat tariffs or tariffs that comprise a combination of a flat tariff and a non-flat tariff, in the period 1 January 2020 to 31 December 2020 (the VDO compliant maximum annual bill).

We may also provide instructions on how to deal with overpayments made by customers where the annual bill amount exceeds the VDO compliant maximum annual bill.<sup>8</sup>

## Victorian Default Offer pricing framework

### 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.<sup>9</sup>

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<sup>5</sup> The order is available at <http://www.gazette.vic.gov.au/gazette/Gazettes2019/GG2019S208.pdf>. The amended Schedule is available at <http://www.gazette.vic.gov.au/gazette/Gazettes2019/GG2019S216.pdf>.

<sup>6</sup> Clause 9 of the order confers functions and powers to the commission, noting that the supply or sale of electricity under the Electricity Industry Act (2001) are specified as prescribed goods and services in respect of which the commission has the power to regulate prices, and that the commission may not make a price determination regulating tariffs for the supply or sale of electricity under the Act except as contemplated under the order.

Clause 10 of the order requires we make a price determination at least 37 days before the commencement of regulatory period commencing 1 January 2020.

<sup>7</sup> Clause 11 of the order specifies the regulatory period and provides that the commission may extend or reduce the regulatory period by up to six months.

<sup>8</sup> Clause 10(2)(b) of the order.

<sup>9</sup> Clause 3 of the order sets out the objective of the VDO.

### Overview

## We need to consider a number of matters in determining VDO prices

In making the VDO price determination we must adopt an approach and methodology that best meets the objectives of:<sup>10</sup>

- the Victorian Default Offer
- the Essential Services Commission Act 2001 (ESC Act), and
- the Electricity Industry Act 2000 (EI Act).

The VDO price determination must be based on the efficient costs of the sale of electricity by a retailer<sup>11</sup>, having regard to:

- wholesale electricity costs
- network costs
- environmental costs
- retail operating costs, including modest costs of customer acquisition and retention<sup>12</sup>
- retail operating margin<sup>13</sup>
- any other costs, matters or things we consider appropriate or relevant.<sup>14</sup>

The VDO compliant maximum annual bill must be based on the VDO tariffs as well as domestic and small business customers' electricity usage.<sup>15</sup>

## VDO price determination and other standing offers tariffs

As set out in the order, the VDO tariffs are the tariffs to be determined by the commission in a VDO price determination from 1 January 2020.

For the regulatory period commencing 1 January 2020 retailers can continue to make other types of standing offers available to customers. Retailers must however ensure that their other standing offer tariffs (i.e. standing offers that are not flat tariff standing offers or which comprise offers with a combination of flat and non-flat tariffs) are set such that the annual bill a customer is to pay in a regulatory period does not exceed the VDO compliant maximum annual bill.

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<sup>10</sup> Clause 12(1) and (2) of the order.

<sup>11</sup> Clause 12(8) of the order does not require the commission to determine tariffs based on the actual costs of a retailer.

<sup>12</sup> Clause 12(6) of the order instructs the commission to exercise discretion in determining an allowance for modest costs of customer acquisition and retention.

<sup>13</sup> Clause 12(7) of the order instructs the commission to exercise discretion in determining 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. Clause 12(9) of the order does not require the commission to determine tariffs based on the actual retail operating margin of a retailer.

<sup>14</sup> Clause 12(10) of the order also notes that the VDO price determination will not include an allowance for headroom.

<sup>15</sup> Clause 12(5) of the order.

While this issues paper does consider how we might determine the VDO compliant maximum annual bill, consideration of an approach to reference pricing is not within its scope. However, we will address reference pricing as part of our reforms to ensure energy contracts are clear and fair, as noted in a separate issues paper published in June 2019.<sup>16</sup>

## Timelines and providing feedback to our determination process

The proposed milestones and timeline are set out below.

Key milestones	Indicative date
Issues paper released and consultation commences	23 July 2019
Issues paper consultation close	12 August 2019
Technical workshop	August 2019
Draft decision and draft determination	Late September
Draft decision and draft determination – public forum	Late September/early October
Final decision and final determination	By 25 November 2019

The commission is committed to providing opportunities for stakeholders to engage with us and provide views on our proposals – consistent with the requirements of our stakeholder engagement framework.<sup>17</sup> The nature of our engagement will also be informed by feedback to this paper.

Our draft advice to government (provided in March 2019) contained estimated tariffs for domestic and small business customers in each distribution zone based on current data, and our proposed cost stack and approach. This time, our draft decision in late September will set out our proposed cost stack and approach, but we may not publish estimates for tariffs since available data for large components of the cost stack, such as network costs, wholesale costs and environmental costs, will change between the release of the draft decision and the final decision (potentially causing confusion). However, we expect there will be sufficient information in our draft decision to enable

<sup>16</sup> Essential Services Commission, Ensuring energy contracts are clear and fair: issues paper, June 2019, p. 21-22.

<sup>17</sup> Clause 14 of the order requires we undertake a consultation process that has regard to our Charter of Consultation and Regulatory Practice, available at our website <https://www.esc.vic.gov.au/about-us/how-we-regulate/stakeholder-engagement-framework>.

customers and electricity retailers to get an early indication of the direction of prices, and the implications for customer bills.

### Cost information request

We are in the process of developing a formal request that would seek cost data across all retailers. After review of the data available to us in reaching our May 2019 final advice, we acknowledged that tailored cost data may increase our understanding of what efficient costs might be. We highlighted this in our final advice, signalling that we would look to gather and analyse more data. As such, we intend to pursue a data collection approach now, while being mindful to minimise regulatory burden. We note that disaggregated cost information of this type is not publicly available, and it will be appropriate for the commission to use its formal information gathering powers.<sup>18</sup>

### Contents of our issues paper

The remainder of this paper is structured in two main sections. Section one outlines our proposed approach to estimating each cost component of the VDO, building on our approach to the final advice we provided to the Victorian Government in May 2019. We have outlined key areas in which we seek feedback from stakeholders to assist in refining our approach. Section two covers the allocation of costs and tariff structure. It also addresses the development of a VDO compliant maximum annual bill that would apply to standing offer tariffs other than those specified under the order. The paper concludes with a brief discussion of our role in formulating a maximum price for embedded networks.

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<sup>18</sup> Section 37 of the Essential Services Commission Act (2001) provides for the commission to request information from a regulated entity.

## How to provide feedback to our issues paper

We invite stakeholders to make submissions in response to this issues paper.

Submissions should be made by **5pm 12 August 2019**. We acknowledge that this timeframe is shorter than usual given the deadlines faced by the commission.

Submissions, preferably in electronic format, and marked Submission to Victorian Default Offer – issues paper, should be sent by email to [retailenergyreview@esc.vic.gov.au](mailto:retailenergyreview@esc.vic.gov.au)

or by mail to:

Essential Services Commission  
Level 37, 2 Lonsdale Street  
Melbourne, Victoria 3000

Submissions will be made available on the commission's 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.

## Approach to estimating cost components

Setting a VDO price for flat tariff standing offers (VDO tariffs) involves two stages. First, estimation of the efficient costs of the sale of electricity by a retailer is dealt with in this section. Second, conversion of the efficient cost estimates into VDO tariffs with both fixed supply and variable usage components. VDO tariffs will also inform the calculation of a VDO compliant maximum annual bill – which is dealt with in section two.

Our approach to estimating the cost components we use in calculating VDO tariffs has been developed through consultation with our stakeholders in a number of papers and forums:

- a staff working paper in December 2018<sup>19</sup> – the staff paper outlined an initial approach to how we might estimate VDO tariffs, it led and informed consultation for our next formal paper, the draft advice.
- a technical workshop held in January 2019 – the workshop was attended by a large number of electricity retailers and some consumer groups and electricity distributors. It provided another opportunity for stakeholders to comment on the methodology we proposed in our staff paper.
- our draft advice paper to government in March 2019<sup>20</sup> – our draft advice considered all feedback from the staff paper consultation period and outlined our draft recommendation for the government in terms of an approach and final tariffs.
- a public forum held in April 2019 – the public forum had a similar attendance to the technical workshop and provided an opportunity for stakeholders to comment on our draft recommendation.
- our final advice to government in May 2019<sup>21</sup> – our final advice represented the culmination of consultation and methodological process.

Our final advice recommended a cost based approach to estimating VDO tariffs, which received broad support from stakeholders throughout the process. We propose to continue using a cost based approach as it is a transparent, replicable and well established methodology used by other economic regulators when setting electricity prices.

It is our view that a cost based approach best meets the objective of the VDO<sup>22</sup>, has regard to the matters outlined in the order, and meets the objectives of both the ESC Act and EI Act. It also

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<sup>19</sup> Essential Services Commission (2018), Victorian Default Offer for domestic and small business electricity customers: Staff working paper, 21 December.

<sup>20</sup> Essential Services Commission (2019), Victorian Default Offer to apply from 1 July 2019: Draft advice, 8 March.

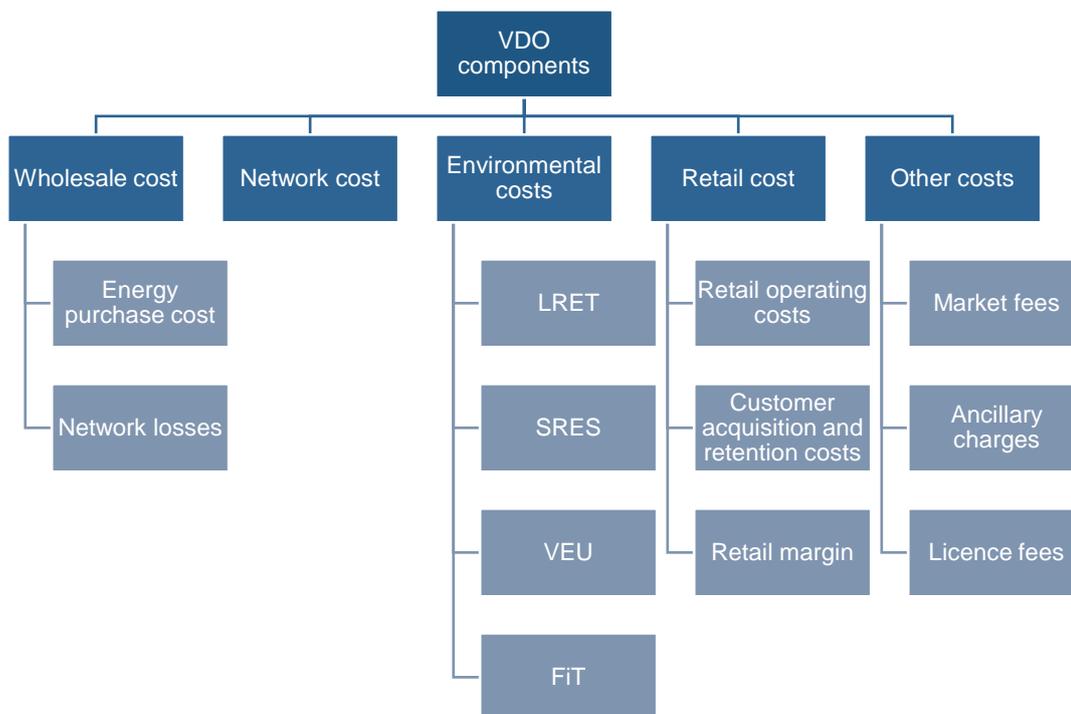
<sup>21</sup> Essential Services Commission (2019), Victorian Default Offer to apply from 1 July 2019: Advice to Victorian Government, 3 May.

provides regulatory consistency with our previous advice. We do not believe the order gives rise to a need for significant change from our advice to government.

Our approach considers the main costs faced by electricity retailers:

- wholesale electricity costs – including hedging costs and network losses for electricity
- network costs – which are directly taken from revenue determinations by the Australian Energy Regulator
- environmental costs – including national renewable energy schemes and the Victorian Energy Upgrades program
- retail operating costs – including modest costs of customer acquisition and retention<sup>23</sup>
- retail operating margin – which is applied to all underlying costs<sup>24</sup>
- any other costs, matters or things the commission considers appropriate or relevant – including previous methodology and advice for each cost component.

Figure 1 VDO components for retail electricity



<sup>22</sup> Clause 3 of the order states 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.

<sup>23</sup> Clause 12(6) of the order states that the commission must, in the exercise of its discretion, determine the amount of modest costs of customer acquisition and retention.

<sup>24</sup> Clause 12(7) of the order states that 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.

Figure 2 illustrates how each element of the cost stack contributes to an indicative average bill under the VDO tariffs that apply from 1 July 2019. Some parts of the cost stack, such as network costs, make up a large part of the bill but are largely passed through.<sup>25</sup> In developing this issues paper we have considered both the contribution of each cost stack element to the overall VDO tariff, as well as the way in which the order impacts how we should account for each cost stack element.

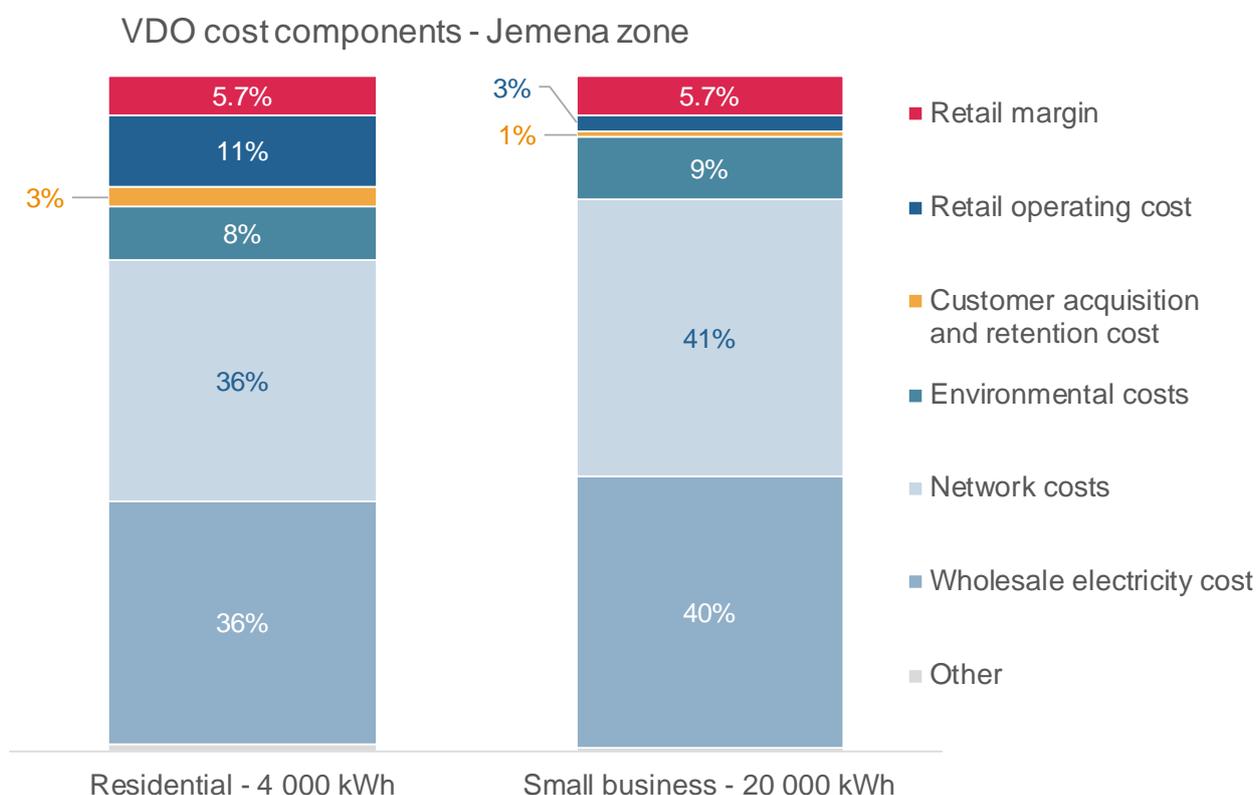


Figure 2 Indicative cost stack build up based on tariffs from final advice to government

### Wholesale electricity costs

In making a VDO price determination, the order sets out that we need to have regard to the efficient costs a retailer incurs when purchasing electricity from the wholesale market to meet the demand of their customers.<sup>26</sup> Retailers must manage the risk of exposure in the spot market (which is volatile), against revenue generated through retail prices that are usually left unchanged for a period of time.

In developing our final advice to the Victorian Government we undertook thorough consultation with stakeholders on our proposed methodology for calculating wholesale electricity costs. The

<sup>25</sup> A cost pass-through refers to costs levied on retailers being passed directly through to retail customers.

<sup>26</sup> Clause 12(4)(a) of the order.

process included a staff working paper setting out options, a technical workshop facilitating stakeholder views on key inputs, and draft advice outlining our proposed cost allowance for wholesale electricity.

Stakeholders demonstrated broad support for a futures market approach as it reflects the way many retailers manage their wholesale electricity purchasing.<sup>27</sup> Our recommendation was to construct a least-cost hedging portfolio to minimise costs for supplying customer load, given efficient risk management. This generated feedback on the following issues:

- Estimation of consumption load data – in developing the likely half-hour load of retail customers we utilised Manually Read Interval Meter (MRIM) data from the Australian Energy Market Operator (AEMO). Some retailers questioned the use of MRIM data in its publicly available form as it includes customers with consumption up to 160 megawatt hours (MWh), while the VDO is only available to customers using less than 40 MWh per year. Our final advice used data over a two-year period, splitting it by domestic and small business customers with consumption less than 40 MWh per year. We sourced the corresponding likely half-hourly spot price from the National Electricity Market’s Victorian spot prices for the same period. We then took the median wholesale cost estimate from a Monte Carlo simulation producing 500 simulated forecasts of the year 2019-20 using the data above.
- Futures contracting period position – in determining a forecast for future prices (used to calculate a set of efficient contracting options) we utilised ASX Energy contract prices. Retailers told us they generally purchase over a 1-2 year period, we adjusted our approach to reflect this – using a 12 month weighted average period. To provide transparency to stakeholders we used publicly available data, publishing spread sheets detailing the contract positions estimated by Frontier Economics’ STRIKE model. We recognise that some stakeholders believe this approach lacks transparency and we will continue working with stakeholders on this issue.
- Volatility – our final advice assumes retailer are risk averse when purchasing futures contracts to deal with market volatility in the wholesale market, in addition to volatility allowances. Some retailers stated that they face a higher level of volatility, risk and therefore costs than was provided for by the MRIM data in our analysis. We propose to continue using the approach from our final advice. However, we are seeking to better understand how this volatility affects the cost to serve customers across the market as the costs of volatility and the approach to risk appears to differ between retailers.

We plan to maintain the existing approach to estimating wholesale electricity costs, where possible updating for the latest available data. It is our view that this approach is consistent with requirements under the order.

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<sup>27</sup> Our final advice did note that we may consider whether alternatives to the futures market approach would be suitable in the future. Given the limited time available for researching, consulting and preparing this determination we are not proposing to explore alternatives at this time.

## Network losses

When electricity is transported through transmission and distribution networks, some of it is lost in the process. Electrical losses occur in both the transmission and distribution networks because of electrical resistance in the wires which converts 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 final advice for VDO tariffs commencing 1 July 2019 recommended using the latest available data published by AEMO on average distribution loss factors and marginal loss factors to estimate network losses.

We plan to maintain the existing approach to estimating network losses where possible updating for the latest available data.<sup>28</sup> In reaching a determination we are seeking stakeholder input on our proposed methodology.

## Network costs

Network costs represent the costs of building, operating and expanding the electricity distribution and transmission networks. In Victoria, there are five electricity distribution networks, each with its own specific requirements in terms of maintenance, expansion and cost allocation. The charges levied by network providers are approved by the Australian Energy Regulator on an annual basis.

Our final advice to the Victorian Government treated network costs, as well as Advanced Metering Infrastructure costs (i.e. smart meters) as a pass through to customers – where the costs levied on retailers are passed onto retail customers. In making a VDO price determination that best meets the objectives set out in the order, we need to have regard to network costs incurred by a retailer.

In addition to calculating the VDO price for standing offer tariffs that are flat (and controlled load for domestic customers), the order requires that from 1 January 2020, the VDO must apply to other types of standing offers, including those with time of use and flexible rates. However, the order also requires the VDO compliant maximum annual bill to be based on flat VDO tariffs and a customer's annual consumption.

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<sup>28</sup> AEMO's final advice for both the distribution and marginal loss factors for the period 1 July 2019 to 30 June 2020 was published in March 2019 (with updates to both provided in June 2019).

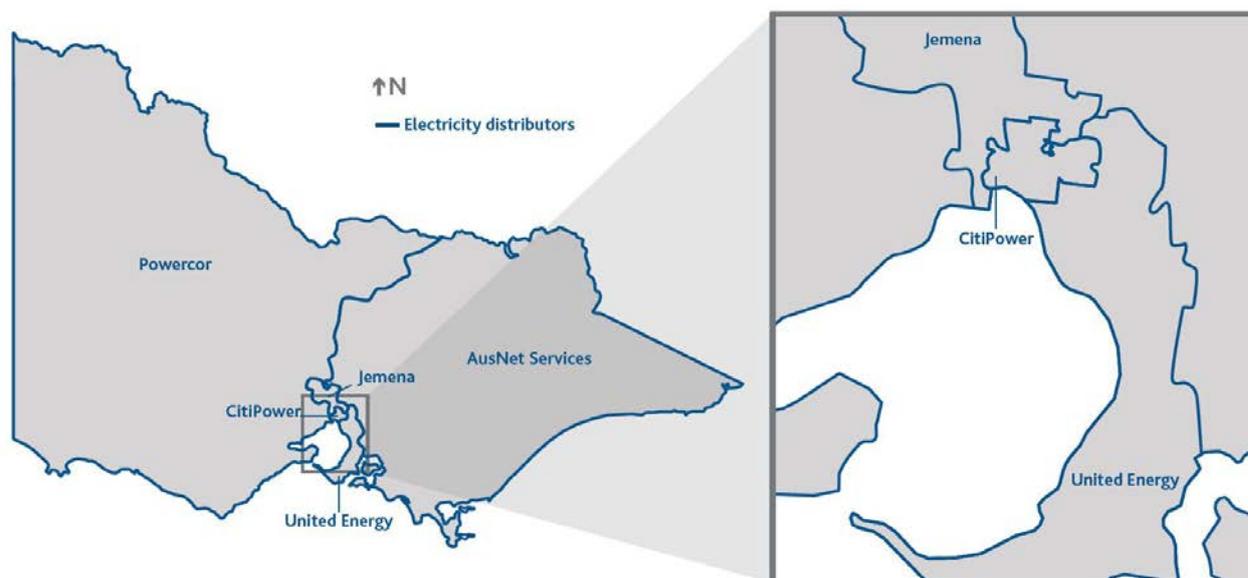


Figure 3 Victorian Electricity Distribution zones

Given the VDO tariffs in the first regulatory period will be determined as a flat standing offer tariff (with controlled load for domestic customers), it is our intention in calculating network costs to maintain the approach from our final advice, including the simplest network use of service tariff in each distribution zone – a daily supply charge and a flat usage charge, shown in table 1 below. We also intend to include metering charges for each distribution zone, and a controlled load option for domestic customers (shown in table 2 below).

We note that the Australian Energy Regulator will approve the 2020 tariff proposals for Victoria’s electricity network (to commence 1 January 2020) later in 2019. We also anticipate United Energy’s LVS1R residential tariff and LVM1R small business tariff will be simplified by the removal of seasonality.<sup>29</sup>

<sup>29</sup> United Energy indicated its intention to simplify both tariffs from 1 January 2020 in a submission to the Victorian Default Offer draft advice received in April 2019.

Table 1 Network tariff categories

Distributor	Domestic tariff	Small Business tariff
AusNet	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/F100a/T100b
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 2 Controlled load network tariff categories

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

- Are the tariffs set out in table 1 and 2 still the most appropriate tariffs to use in setting the VDO?
- Are there other issues – such as more complex tariff structures, we should consider in calculating network costs? How should these be resolved?

## Environmental scheme and other regulatory costs

There are four main environmental costs faced by Victorian electricity retailers:

- Large-scale Renewable Energy Target (LRET) – a Commonwealth Government scheme that encourages renewable energy generation by creating a market for renewable energy certificates.
- Small-scale Renewable Energy Scheme (SRES) – a Commonwealth Government scheme that supports the installation of small-scale renewables, such as household solar rooftop panels and solar hot water systems.
- Victorian Energy Upgrades (VEU) – a state-based program that places a liability on Victorian energy retailers (both electricity and gas) to surrender a specified number of Victorian Energy Efficiency Certificates each year.
- Feed in tariff (FiT) – retailers credit small scale renewable energy exports with the minimum feed-in tariff that includes an allowance for the avoided social cost of carbon.

In addition to this, retailers also incur a range of other regulatory costs, such as market participant fees, ancillary service charges, the Reliability and Emergency Reserve Trader scheme costs, and licence fees.

Our final advice for implementation of the first VDO tariffs (commencing 1 July 2019) recommended basing our estimated environmental scheme cost charges on market data and other publicly available data. For other regulatory costs we recommended basing them on publicly available information.

We do not plan to change this approach to determining environmental scheme and other costs aside from updating for the latest information. We propose to use a market based approach to estimate environmental scheme costs and publicly available data to estimate other costs.

For each of the environmental scheme costs we propose:

- LRET – the Renewable Power Percentage is multiplied by the market price for large-scale generation certificates.
- SRES – the small-scale technology certificates is multiplied by the clearing house price.<sup>30</sup>
- Victorian Energy Upgrades – the greenhouse reduction rate for electricity is multiplied by the 12 month average price for Victorian Energy Efficiency Certificates.

The above costs are multiplied by network loss factors.

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<sup>30</sup> The Clean Energy Regulator operates a clearing house for small-scale renewable energy system owners (and registered agents) to sell small-scale certificates at a fixed price.

- FiT (social cost of carbon) – total renewable exports divided by average total domestic and small business customers, multiplied by the social cost of carbon (2.5 cents).<sup>31</sup>

For other regulatory costs:

- AEMO market fees – estimates taken from the latest available publication.
- Ancillary fees – forecast taken from the Australian Energy Market Commission residential price trends.
- Reliability and Emergency Reserve Trader – based on the latest estimates of charges released by AEMO.
- Essential Services Commission licence fees – market wide average of fees paid, adjusted for inflation (if necessary).

The Australian Energy Regulator has released a set of guidelines for the Retailer Reliability Obligation to support improved reliability in the National Electricity Market.<sup>32</sup> As the first chance that a reliability gap will be identified under the Retailer Reliability Obligation will not occur until late 2022 it will not impact the cost of wholesale electricity purchases for sale in 2020. For this reason we are not proposing to consider the Retailer Reliability Obligation costs for the regulatory period beginning 1 January 2020.

- Does this cover all environmental and other costs?
- Are there other more relevant sources or evidence we should consider?

## Retail operating costs

Retail operating costs reflect a range of costs incurred by an electricity retailer in conducting its business, including: billing and revenue collection systems, IT systems, call centre costs, corporate overheads, energy trading costs, provision for bad and doubtful debts, and regulatory compliance costs. Subclause 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. In line with our final advice we deal with customer acquisition and retention costs separately.

In developing an approach to estimating retail operating costs, our staff working paper in December 2018 expressed a desire for retailers to volunteer cost data for comparison with publicly

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<sup>31</sup> Victoria Government Gazette No. S 36, Tuesday 21 February 2017.

<sup>32</sup> More information on Retailer Reliability Obligations and the Australian Energy Regulator's development of guidelines can be found at <https://www.aer.gov.au/retail-markets/retailer-reliability-obligation>.

available benchmark data.<sup>33</sup> After receiving limited data from retailers to inform our analysis, our draft advice to the Victorian Government recommended a benchmarking approach to estimate retail operating costs, based on data from the Australian Consumer and Competition Commission's Retail Electricity Pricing Inquiry (ACCC inquiry). While this data was the latest available data at that point, we received feedback from a range of retailers suggesting that the ACCC inquiry's benchmark may not have included all costs borne by a retailer when selling electricity. After completing more analysis, we based our final advice on the most recent regulatory benchmark for retail operating costs used by the Independent Competition and Regulatory Commission in its most recent regulatory decision for electricity prices in the ACT, with some allowance for new regulation and Victorian specific costs.

We propose to continue using the benchmarking approach to estimate retail operating costs, noting our intention to gather cost data to provide additional context to public benchmarking data.

We are developing a formal request that would provide consistent data across all retailers, while being mindful to minimise regulatory burden. This data may be used in a similar way to the data submitted voluntarily by electricity retailers to our draft advice informed our consideration of a reasonable benchmark. We note that disaggregated cost information of this type is not publicly available and it will be appropriate for the commission to use its formal information gathering powers.<sup>34</sup>

The allowance for retail operating costs should be considered in conjunction with the allowance for customer acquisition and retention costs, set out in the following section.

- Have any major changes occurred to retail operating costs since May 2019 when we submitted our final advice to Government? If so, what is the nature and magnitude of these changes?

## Customer acquisition and retention costs

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

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<sup>33</sup> This aligns with the Australian Energy Market Commission's advice on a best practice methodology for setting regulated retail electricity prices for small customers. Their advice identifies two methods for estimating the efficient retailer's costs; a benchmarking approach and a bottom-up approach, recommending the use of both methods as tools in coming to a final estimation for retail operating costs. Australian Energy Market Commission (2013), Advice on best practice retail price methodology, Final Report, 27 September, p 60.

<sup>34</sup> Section 37 of the Essential Services Commission Act (2001) provides for the commission to request information from a regulated entity.

As mentioned in the previous section, we are to include a modest allowance for customer acquisition and retention costs in having regard to retail costs under the order.

Our final advice to government recommended using a benchmarking approach to determine an allowance for customer acquisition and retention costs. To arrive at our recommendation we considered recent regulatory decisions, publicly available retail cost information, and the ACCC inquiry.

As discussed in our staff paper, we considered the ACCC inquiry data as the most appropriate publicly available benchmark. In our draft advice we used the most recent data (2016-17) for competitive markets in the ACCC inquiry final report, instead of the Victoria specific benchmark. This was based on the view that as the state with the highest customer acquisition and retention costs, spending in Victoria was unlikely to be modest.

Feedback in response to our draft advice suggested that the data from 2016-17 were not modest. Evidence suggested that in markets which were deregulated, instead of competition driving efficiency, it instead created a situation where retailers spent increasing amounts pursuing the same pool of customers. Considering this feedback in our final advice, we recommended using ACCC inquiry data from 2013-14 on the basis that it is the most robust data currently available that also limits the impact of the increased spending on customer acquisition and retention costs that had been observed across most Australian jurisdictions in the past five years.

Some retailers claimed the amount we set for the modest customer acquisition and retention costs would not allow for new entrants to gain market share. Our final advice noted that the objective of the VDO is to be based on efficient costs, and does not require our approach to account for higher costs. Further, we expect high customer acquisition and retention costs for new entrants would usually be funded in the short term through equity or foregone profits as occurs in other competitive markets.

In addition, as set out in the terms of reference, and now in the order, the VDO is intended to provide a simple, trusted and reasonably priced option for customers who are either unable or unwilling to engage with the retail electricity market. Customers on standing offers often do not change retailers and are unlikely to be large contributors to customer acquisition and retention costs.

Our final advice was based on the information currently available to us, noting that we would review the allowance for customer acquisition and retention costs in subsequent decisions to be made about VDO tariffs. As noted above in the retail operating cost discussion, we are developing a formal data request that would provide consistent data across all retailers, this may be used to add further context to the benchmark data.

- Are there any new sources of data that we should consider to estimate a modest allowance for customer acquisition and retention costs?

Approach to estimating cost components

## Retail operating margin

The order requires that in making a VDO price determination we have regard to retail operating margin.<sup>35</sup> 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.<sup>36</sup> Retail operating margin is expressed as a percentage of the cost stack. The order notes it is important that risks accounted for in other components of the cost stack (such as wholesale electricity market risk) are not included in the retail operating margin.<sup>37</sup>

Our final advice on the VDO commencing 1 July 2019 used a benchmarking approach based on recent decisions by Australian energy regulators to estimate retail operating margin. This was comparable to, and within the feasible range of the margin estimated by Frontier Economics using the expected returns approach.

It is our intention to continue using a benchmarking approach in estimating retail operating margin.<sup>38</sup>

- Are there other issues we should consider in determining retail operating margin?
- How could we resolve these issues in determining VDO tariffs for the first regulatory period (1 January 2020 to 31 December 2020)?

## Variation of a VDO price determination

The order provides for the commission to make a variation to the VDO price determination – including changing the length of the regulatory period.<sup>39</sup> In making our price determination we must specify the circumstances and basis on which we would consider a variation, and describe the process to enable a proposed variation. In most cases, any variation to a price determination would involve consultation with stakeholders, in accordance with our Stakeholder Engagement

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<sup>35</sup> Clause 12(4)(e) of the order.

<sup>36</sup> Non-diversifiable risks are considered to be unavoidable, and are typically attributable to market factors that affect all firms.

<sup>37</sup> 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.

<sup>38</sup> Our final advice signalled we may undertake our own research into retailer margins in the future. Given the limited time available for researching, consulting and preparing this determination we are not proposing to explore alternatives at this time.

<sup>39</sup> Clause 13 of the order.

Framework.<sup>40</sup> Where the variation is not sufficiently material or the need for the variation is urgent, we may not engage in a full public consultation process.

Price determinations are often varied for a range of reasons, which could include:

- uncertain or unforeseen circumstances (e.g. changes in environmental schemes or other regulatory costs such as licence fees)
- material error or unintended consequences (e.g. errors, mistakes or false information).

The commission is now seeking stakeholder feedback about the issues and circumstances that might require the commission to vary a VDO price determination and the appropriate process to follow.

- In what circumstances should the commission consider, and on what basis should the commission decide on, a proposed variation to a VDO price determination?
- What process should the commission adopt in varying a VDO price determination?

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<sup>40</sup> Clause 13(4) notes that before making a variation we must consult with stakeholders in a manner we see fit (having regard to our Charter of Consultation and Regulatory Practice).

Clause 13 (6) notes that where a retailer is (or will be) required to vary standing offer tariffs, the commission must ensure the retailer is given adequate notice before the variation to the VDO price determination takes effect.

Approach to estimating cost components

# Calculating the Victorian Default Offer price

In this section we look at how the commission might approach cost allocation and tariffs, and other matters we may need to consider.

This includes how we propose to reflect the costs described in the previous section when setting VDO tariffs and how we deal with standing offers that do not have a flat tariff structure under the VDO compliant maximum annual bill.

## VDO tariffs

To set the VDO tariffs, the commission must determine an appropriate tariff structure and how to allocate costs within that tariff structure.

### Tariff structure

Once the commission has determined the allowances for efficient costs of selling electricity, we need to convert the costs described in the previous section into a set of VDO tariffs. The approach we take will be guided by the order, which states that the VDO is to be a simple, trusted and reasonably priced offer available to safeguard customers who are unwilling or unable to engage in the market.

The VDO applying from 1 July 2019 is a simple tariff structure including a dollar per day supply charge, and a cents per kilowatt hour (kWh) flat, anytime usage charge. The order supports this approach from 1 January 2020<sup>41</sup>, by specifying that our price determination must set VDO tariffs in each distribution zone that apply in respect of:

- flat tariffs
- flat tariffs with a controlled load (in the case of domestic customers).

To meet the requirements of the order and maintain consistency, we propose that the VDO tariffs will be set under the same structure as in our final advice to government with a daily supply charge, a flat, anytime usage charge, and a controlled load charge for domestic customers.

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<sup>41</sup> Clause 10(2)(a) of the order.

## Cost allocation

Under the VDO that applies from 1 July 2019, we recommended allocating fixed costs to the daily supply charge component and any costs that vary with consumption to the variable, per kWh charge component of the VDO price. This took the form of:

### **Daily supply charge (fixed costs) =**

(retail operating costs, including customer acquisition and retention + fixed network costs + per customer ancillary and FiT social cost of carbon) x (1 + retail operating margin)

### **Usage charge (variable costs) =**

(wholesale electricity costs + environmental program costs + variable ancillary costs + electricity network losses + variable network costs) x (1 + retail operating margin)

We propose to follow this approach as a simple and logical way to allocate fixed and variable costs for the 1 January 2020 VDO price determination.

- Is there any new evidence that suggests another approach could be taken to allocating costs between dollars per day and per kilowatt hour charges?
- Are there any other matters we should consider when allocating fixed and variable costs?

## VDO compliant maximum annual bill

Under the order, in the period 1 July to 31 December 2019 the VDO only applies to standing offers with a flat tariff structure (plus controlled load for domestic customers). From 1 January 2020 the commission must determine these VDO tariffs. The order also sets out that we must determine the maximum annual electricity bill amount for domestic and small business standing offer customers on non-flat tariffs or any combination of a flat and non-flat tariff.<sup>42</sup> This amount is the VDO compliant maximum annual bill, and would cover tariffs where usage charges vary at different times of the day, such as time of use or flexible tariffs.

The order states the VDO compliant maximum annual bill must be based on<sup>43</sup>:

- the standing offer tariffs that the commission determines are to apply in respect of flat tariffs
- the prescribed customer's electricity usage.

A simple approach we propose to meet this requirement would be to calculate the compliant maximum annual bill amount using the VDO price we determine for flat tariffs for a single level of consumption.<sup>44</sup> We would calculate the daily charge cost for one year and multiply the flat, anytime usage charge by a customer's annual electricity usage at a specific level. This is consistent with the approach in Schedule 3 (clause 1) of the order, which specifies that consumption amounts for domestic and small business customers are 4,000 kWh and 20,000 kWh per annum, respectively.

Under this approach, retailers could structure non-flat standing offer tariffs that comply at the specific consumption point. However, the impact on consumers with different electricity consumption (to the point chosen) would be uncertain.

An alternative approach is for the commission to calculate the compliant maximum annual bill amount using the VDO price we determine for flat tariffs for the full range of consumption levels covered by the VDO. That is, a maximum bill amount would be identified for consumption ranging from zero to 40,000 kWh per year. At this stage, we prefer this approach as it promotes transparency, allowing a maximum annual bill amount to be calculated and available to a customer with any consumption level. This approach also meets the specific requirement of the order that the maximum annual bill amount be based on the electricity usage of the particular customer.

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<sup>42</sup> Clause 10(2)(a) of the order.

<sup>43</sup> Clause 12(5) of the order.

<sup>44</sup> This is similar to the approach adopted by the Australian Energy Regulator for setting the Default Market Offer. See Australian Energy Regulator, Final Determination: Default Market Offer Prices 2019-20, April 2019.

Box 1 provides a worked example of how each approach might be calculated for a small business customer in the CitiPower distribution zone using the VDO tariffs for the period 1 July to 31 December 2019.

### **Box 1 – Worked example to calculate the VDO compliant maximum annual bill**

#### Approach 1: Maximum annual bill for a single point of usage

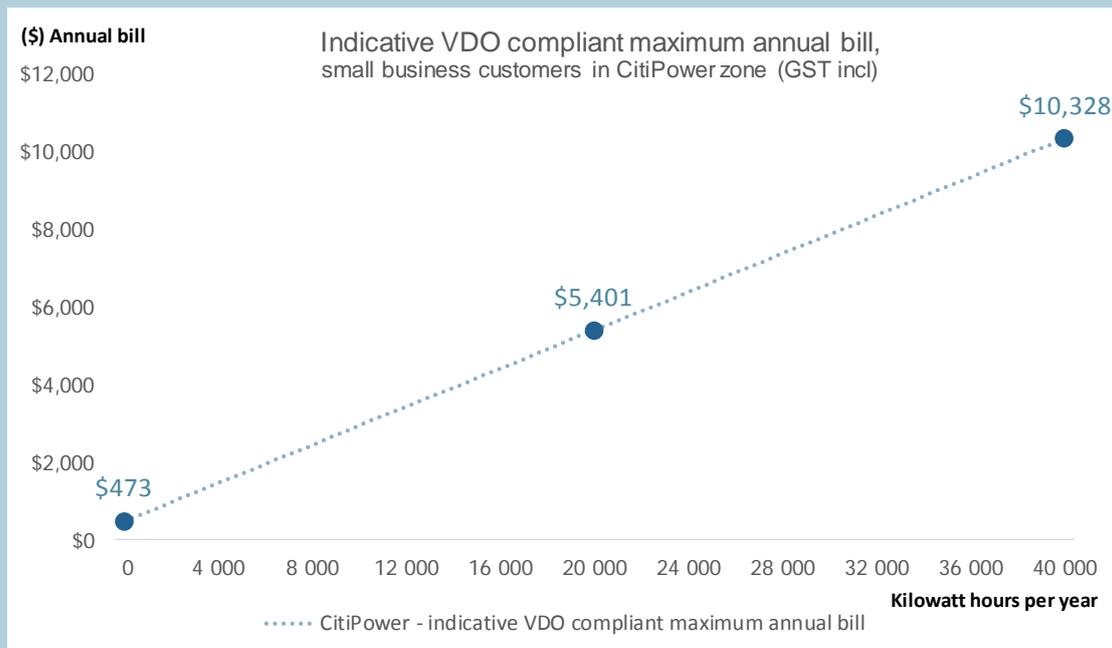
For a small business customer in the CitiPower distribution zone, the specified consumption level is 20,000 kWh per annum. The maximum annual bill for this customer would be:

$$(\$1.2972 \times 365) + (\$0.2464 \times 20,000) = \$5,401$$

Under this approach, a retailer would need to compare the bill paid by a small business customer in the CitiPower distribution zone compared with the maximum annual bill. While this is simple for customers who consumed 20,000 kWh per annum, a retailer would need to establish how the bills for customers whose consumption of electricity was above or below the specified point of usage compared with the maximum annual bill.

#### Approach 2: Maximum annual bill for a range of consumption

While this approach does not specify a single maximum annual bill amount, it does allow for a maximum annual bill to be calculated for customers at any consumption level. The chart below shows how this might operate for small business customers in the CitiPower distribution zone for the range of consumption from zero to 40,000 kWh per annum. For a customer with zero consumption, the maximum annual bill is \$473 per annum. At the other end of the range the maximum annual bill for consumption of 40,000 kWh per annum is \$10,328. The chart also shows the maximum annual bill calculated under approach 1. The chart highlights the maximum annual bill at three specific points of consumption, but the dotted line between each of the points indicates what the maximum annual bill would be for every possible consumption level in the range.



Under each of the approaches, retailers would be required to establish that the bill paid by a customer on a non-flat tariff standing offer did not exceed the VDO compliant maximum annual bill for a regulatory period. This may lead to a number of possible scenarios:

- None of the rates a retailer charges under a non-flat standing offer tariff are above the VDO tariffs. A retailer could choose to offer off-peak rates that are below the VDO anytime tariff, but the peak rate could be no higher than the VDO tariffs. There would be no risk to the retailer of any customer's bill exceeding the VDO compliant maximum annual under this scenario.
- Based on their understanding of their customers' usage profiles, a retailer may charge peak rates on their non-flat standing offer tariffs that are above the VDO tariffs, with this expected to be offset by customer savings from shoulder or off-peak rates below the VDO tariffs. Under this scenario, the retailer would risk the possibility that a customer's bill may exceed the VDO compliant maximum annual bill. The commission would have a number of options available to monitor retailer compliance under this scenario. The order also provides that (for domestic and small business standing offer customers on non-flat tariffs or any combination of a flat and non-flat tariffs) the commission may provide for how any overpayment by those customers is to be dealt with.<sup>45</sup>

<sup>45</sup> Clause 10(2)(b) of the order.

- A retailer may withdraw their non-flat standing offer tariffs, and only offer non-flat tariffs in their market offers. This would remove the risk of any customer's bill exceeding the VDO compliant maximum annual under this scenario.

The commission is supportive of the continued development of cost-reflective tariffs in the market. We do not believe that there are any constraints on retailers making cost-reflective tariffs available to customers under market offers. However, there does not appear to be a strong basis for designing a more complex approach for non-flat tariffs under the standing offer framework as the objective of the VDO is to provide a simple, trusted and reasonable priced electricity option.

- Are there any other options we should consider when determining the VDO compliant maximum annual bill that continues to meet the requirements of the order?
- Are there any other issues we should consider regarding the basis for the VDO compliant maximum annual bill?
- How might any overpayment by customers subject to the VDO compliant maximum annual bill amount be dealt with?

## Embedded Networks

Embedded networks are private electricity networks often found in apartment buildings, caravan parks or shopping centres. Various matters relevant for embedded network operators including requesting the commission to formulate a maximum price for embedded networks are set out in a General Exemption Order 2017 made by the Governor in Council under section 17 of the EI Act.<sup>46</sup> The General Exemption Order 2017 was amended on 30 May 2019<sup>47</sup> to provide that, from 1 July 2019 and until the commission formulates a maximum price, the maximum price for embedded networks is frozen at the standing offer prices that were available from the local area retailer in each distribution zone as at 27 May 2019.

We are not proposing to formulate a maximum price for embedded networks through this VDO price determination process. However, we encourage stakeholders to provide views about how we might formulate a maximum price for embedded networks, noting that the VDO may provide a starting point. This will inform our work that we intend to commence later this year.

In particular, we seek views on whether there are major differences in the various costs of providing retail electricity services to customers of embedded networks. We also seek views on impediments to an embedded network customers' ability to access competitive offers from retailers and how that might inform how we set a maximum prices for these customers.

- What are the key issues associated with setting prices applying to embedded networks?
- How do you consider those key issues do or do not affect the approach that should be applied to embedded networks?

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<sup>46</sup> The General Exemption order is made under Section 17 of the EI Act.

<sup>47</sup> By order made by the Governor in Council under section 17 of the EI Act and published in the Government Gazette No. S 208 dated 30 May 2019.