ESSENTIAL SERVICES COMMISSION

Victorian Default Offer 2021

Consultation Paper

16 June 2020

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Contents

We are reviewing the VDO for 2021

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 prepared by the commission,[1] the Victorian Government 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
- specifically asked for a standing offer.[5]

Although prices for standing offers are regulated, electricity retailers can and do supply electricity under market offers on terms that are different to 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 in making a VDO price determination.

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

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[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.

consultation paper begins our engagement process by seeking feedback from stakeholders on our approach and process to determine the tariffs to apply for calendar year 2021.

What the VDO is 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).

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:[8]

- the VDO as set out in the pricing order
- the Essential Services Commission Act 2001 (ESC Act)
- 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,[9] having regard to:

- wholesale electricity costs
- network costs
- environmental costs
- retail operating costs, including modest costs of customer acquisition and retention[10]
- retail operating margin[11]

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

[8] Clause 12(1) and (2) of the pricing order.

[9] Clause 12(8) of the pricing order does not require the commission to determine tariffs based on the actual costs of a retailer.

[10] Clause 12(6) of the pricing order instructs the commission to exercise discretion in determining an allowance for modest costs of customer acquisition and retention.

[11] Clause 12(7) of the pricing 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

- any other costs, matters or things we consider appropriate or relevant.[12]

The VDO compliant maximum annual bill must be based on the VDO tariffs that apply to standing offers with flat tariffs and domestic and small business customers' electricity usage.[13]

We are seeking stakeholders' views

In this paper we set out our initial views on how we plan to make our VDO determination to apply from 1 January 2021.

At this stage, we consider that using largely the same approach as we did in our 2020 VDO price determination (updated for the most recent data available) will best meet our legislative objectives and requirements. That decision was made in November last year and we consider that the approach we used is still appropriate.

Nonetheless we are interested in any feedback stakeholders have on our approach to setting the VDO for this next regulatory period. Among other things we seek views on:

- the impact, if any, of COVID-19 and how this might be taken into account in the VDO
- stakeholders' experiences with standing offers regulated by the VDO compliant maximum bill
- harmonisation of the VDO price determination and electricity distribution network regulatory periods and[14],
- we consider our current variation mechanism is fit for purpose but we seek feedback from stakeholders on its operation including in the context of COVID-19.

As always, we will adapt our decision making process in line with our stakeholder engagement framework to ensure we hear from a wide range of Victorians about how the VDO impacts them. Although this is always important, it is now even more so given the challenges stakeholders are facing due to COVID-19.

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.

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compensate retailers for risks that are compensated elsewhere in the costs. Clause 12(9) of the pricing order does not require the commission to determine tariffs based on the actual retail operating margin of a retailer.

[12] Clause 12(10) of the pricing order also notes that the VDO price determination will not include an allowance for headroom.

[13] Clause 12(5) of the pricing order.

[14] Clause 11 of the pricing order sets the regulatory period length and the process for changes to it.

Table 1: Timeframes for the 2021 VDO review

Key milestones	Indicative date
Consultation paper released	16 June 2020
Cost request	Late June
Consultation paper – public forum	July
Submissions on consultation paper close	21 July 2020
Cost request due	Early August
Draft decision and draft determination	September
Draft decision and draft determination – public forum	October
Final decision and final determination	By 25 November 2020

In addition to the ongoing challenges of COVID-19 we are aware that there are a number of other policy and regulatory reviews affecting the industry. To the extent that it is possible within our statutory timeframes and legislated obligations, we will do our best to structure our consultation process in a way that does not unduly burden stakeholders. We will continue to communicate with consumer groups, industry, and other government bodies to make this happen, but due to COVID-19 we are likely to utilise online tools where possible to replace face to face engagement activities.

While we will consider the economic and regulatory landscape in coming to our decision, this review is focussed solely on our determination for the tariffs to apply for the VDO from January 2021. Changes beyond this are not within the scope of this review.

How to provide feedback

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

Both general comments and formal submissions to our consultation paper should be made by **5pm 21 July 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 .

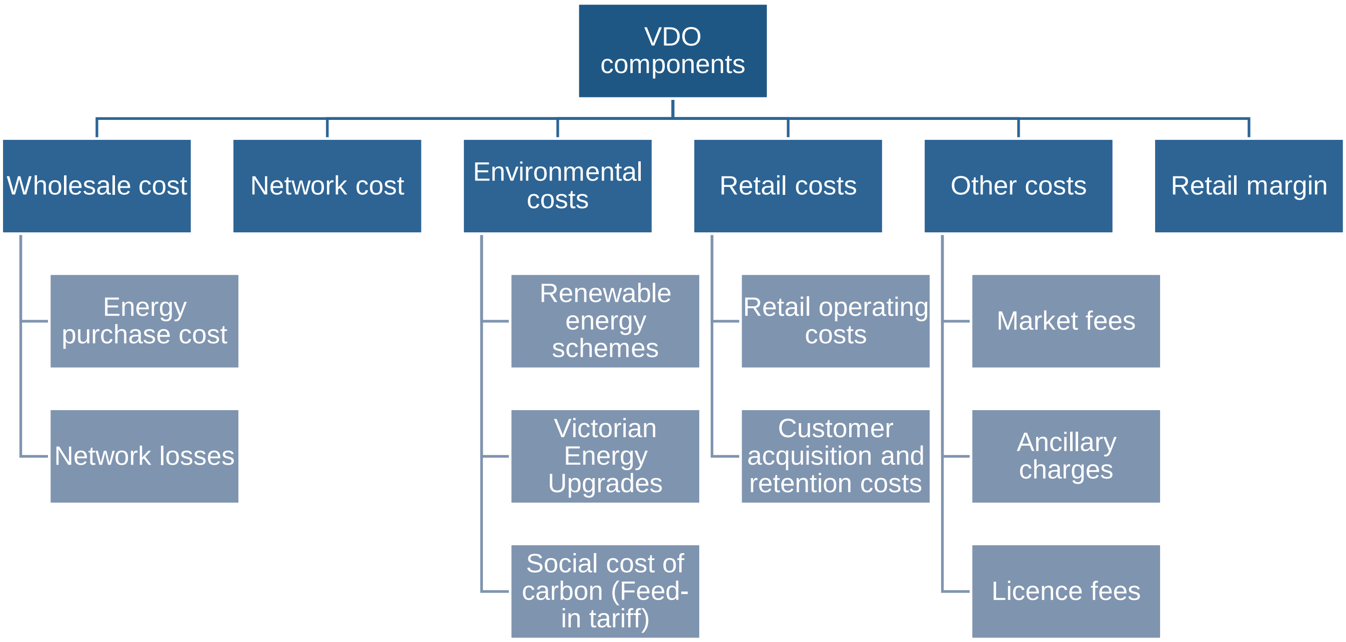
If this presents an issue please email us at VDO@esc.vic.gov.au to discuss other options for making a submission.

All submissions come under the commission's submissions policy. 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.

VDO cost components

In setting the Victorian Default Offer (VDO) tariffs, we assess the efficient costs of providing retail electricity services. Our final decision on the 2020 VDO explained how we calculate the total cost of electricity by looking at the main items used in getting electricity to end users in Victoria.[15] Figure 1 sets out the key items included in the 2020 VDO cost stack.

Figure 1: Cost items included in the VDO cost stack



We consider that these continue to be the main cost categories we should include in the 2021 VDO as they account for the costs associated with generating, transporting and selling electricity to households and small businesses. This also aligns with the categories we must have regard to in the pricing order.

A cost-based approach to setting the VDO was generally supported by stakeholders in our first determination. After seeking input from stakeholders we set up approaches to estimating each item that makes up the total VDO costs. 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 –** taken directly from the tariffs approved by the Australian Energy Regulator

[15] This addresses clause 12(4) of the pricing order that requires the commission to account for a particular set of costs.

- **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.

As part of this review, the estimates included in the VDO cost stack will need to be updated to reflect changes in the market and new data that is now available.

We consider that the methods used to estimate most cost items remain appropriate as we recently concluded the 2020 VDO process in November 2019. We would need to have strong new evidence to change our approach for most cost items.

Using this already established approach should minimise the amount of change and regulatory burden for stakeholders. This certainty may be valuable to stakeholders given the ongoing impacts of COVID-19.

However, our consultation paper does note where issues may arise that warrant further analysis of our approach or data we have available. For example, COVID-19 may have an impact on one or more cost elements. When considering these impacts, we plan to explore where there has been permanent changes to efficient costs across the industry rather than temporary changes that may not justify major shifts in our approach.

The rest of this section discusses the main areas we are seeking feedback on, but we welcome input and supporting evidence in other areas of importance to stakeholders.

Wholesale electricity costs

Retailers must purchase electricity from the wholesale market to meet their customers demand for electricity. Wholesale electricity prices can be volatile, while retail prices often remain unchanged for a relatively long period. This creates risks for retailers.

Some retailers own electricity generators, but many buy electricity directly from generators or the spot market. Buying electricity from the market exposes retailers to the risk that electricity prices may be high when they need to purchase electricity.

Electricity retailers can manage this risk by 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 the Australian Securities Exchange (ASX Energy).

Previously we have used prices from this financial market to estimate wholesale electricity costs. We maintain the view that this approach meets the requirements of the order as well as the ESC

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

Forecasting wholesale electricity costs in this way requires the following inputs:

- the likely half-hourly customer load and corresponding spot prices, and
- retailer hedging positions and the cost of financial hedging contracts.

Half-hourly customer load and corresponding spot prices

Consistent with the approach we have used in the past to estimate electricity consumption (load), we intend to use customers' smart meter data for each of Victoria's five distribution zones.[16] We then split the data into domestic and small business customers, ensuring we only include observations with consumption less than 40 megawatt hours per year.[17]

We then combine this with the Victorian spot price data for the same period.[18] This allows us to determine the relationship between load and spot prices. In determining VDO prices for 2020 we based our forecast on data for the three-year period 1 July 2016 to 30 June 2019.

We then forecast half hourly load and spot prices using a Monte Carlo simulation. This simulation randomly samples the historical data, assigning a sample load and price for each day of the forecast period. This process is repeated to produce 500 simulated years. We then take the median year from the simulations and scale it to align with future contract prices for the regulatory period.

Retailer hedging positions and the cost of financial hedging contracts

In the past we have calculated future prices using hedging contract prices from ASX Energy. A set of efficient contracting options are then calculated (using Frontier Economics' *STRIKE* model). This involves estimating the mix of hedging products a retailer would purchase to mitigate risk exposure. In our past reviews we also included an allowance for the cost of holding working capital to fund spot market purchases.

[16] We will use Manually Read Interval Meter (MRIM) data provided by the Australian Energy Market Operator.

[17] Consistent with requirements under the order which specifies the VDO is to be made available to domestic customers and small business customers 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.

[18] Spot price data is provided by the Australian Energy Market Operator.

We seek stakeholders’ views on wholesale costs

While we plan to continue with our existing approach to estimating wholesale electricity costs, updated for the latest available data, we seek stakeholder views on our approach. In particular, we would like to hear from retailers about the impact of COVID-19 on their wholesale electricity costs. Things COVID-19 may affect could include changes to wholesale prices and changes in consumer demand.

Questions for stakeholders

- Are there any changes or issues we need to consider in relation to the underlying data we use to calculate wholesale electricity costs? In particular, changes to volume or patterns of consumption due to COVID-19 that might extend into the 2021 calendar year?

Network costs

Network costs represent the costs of building, operating and expanding 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.

In our last decision we used a cost pass through approach for estimating network costs, using the simplest network tariff in each distribution zone, generally a daily supply charge and a flat usage charge. The commission also included metering charges for each distribution zone, and where applicable a controlled load option for domestic customers.

We propose to retain this cost pass through approach for the 2021 VDO price review.

Environmental schemes and other regulatory costs

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

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

In addition to these costs, 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.

In our final decision on the 2020 VDO, the commission adopted the following approaches to estimating the above costs.

Environmental Costs:

- Large-scale Renewable Energy Target – the 2020 default renewable power percentage is multiplied by the futures market price for large-scale certificates.
- Small-scale Renewable Energy Scheme – the mid-point of the 2020 non-binding small-scale technology percentage and 2019 binding small-scale technology percentage is multiplied by the clearing house price.
- VEU – the 2020 greenhouse reduction rate for electricity is multiplied by the historic 12-month average price for Victorian Energy Efficiency Certificates.
- The above costs are multiplied by network loss factors.
- Minimum feed-in tariff (social cost of carbon) – total renewable exports in 2018-19 divided by average total domestic and small business customers in 2018-19, multiplied by the social cost of carbon (2.5 cents).

Other regulatory costs:

- Australian Energy Market Operator (AEMO) market fees – simple average of 2019-20 and 2020-21 estimates taken from the latest available publication.
- Ancillary fees – an average of the past 52 weeks (ending 27 October 2019) of ancillary service payments based on AEMO data.
- Reliability and Emergency Reserve Trader – based on the latest historic estimates of charges released by AEMO, adjusted for inflation.
- Essential Services Commission licence fees – market wide average of fees paid in 2018-19, adjusted for inflation.

For the 2021 VDO price review we consider it appropriate to retain the same approaches to estimating environmental costs and other regulatory costs, updating for the most recent available data where necessary and possible. We note that maintaining these approaches will ensure consistency with our approach to estimating wholesale costs.

While we propose to retain our approach, we acknowledge the concerns raised by some stakeholders about the Small-scale Renewable Energy Scheme liability. In particular stakeholders observed the potential for there to be a difference between the forecast small-scale technology percentage and the binding small-scale technology percentage that are published by the Clean Energy Regulator. While we made an adjustment for this in our 2020 VDO price determination, we note that a difference exists between the forecast small-scale technology percentage based on data available to the commission, and the actual binding small-scale technology percentage for last year's VDO period. While we consider that our approach is still appropriate, we welcome feedback on how we may approach estimating the level of small-scale technology percentage in the future.

Questions for stakeholders

- Should we consider any other approaches to accounting for the difference between the forecast and binding small-scale technology percentage?

Recent regulatory events that may affect retailers in 2021

The Australian Energy Market Operator has proposed a rule change to the Australian Energy Market Commission to postpone the introduction of five-minute settlements for another 12 months to 1 July 2022. On this basis we propose not to add an allowance for five-minute settlements in the next VDO. This is consistent with our final decision on the 2020 VDO. If the proposal is not accepted, we will look into how the implementation of five-minute settlements will impact retailers' costs in the next VDO price period.

We are aware that the Retailer Reliability Obligation commenced on 1 July 2019 and is ongoing. We note that at the time of our consultation paper's release it has not been triggered, and it is currently unclear how it would impact retailers' costs to be recovered through the VDO. On this basis we do not propose to add an allowance for the Retailer Reliability Obligation. This is consistent with our final decision on the 2020 VDO.

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
- information technology systems
- call centre costs
- corporate overheads
- energy trading costs
- provision for bad and doubtful debts and
- regulatory compliance costs.

In our last decision we made an allowance for retail operating costs (excluding customer acquisition and retention costs) using a benchmarking approach from the Independent Competition and Regulatory Commission (of the ACT) in 2017.[19]

[19] ICRC, Final report: Standing offer prices for the supply of electricity to small customers from 1 July 2017, June 2017, p. 48. This benchmark is originally derived from Independent Pricing and Regulatory Tribunal (of NSW), which undertook a

Most feedback on our last decision related to the level of the benchmark, rather than the overall method. Most retailers argued for a higher level claiming the benchmark is outdated due to new costs. Consumer groups argued that evidence from other sources indicated that retail costs were lower than this amount we allowed and for this reason the allowance should be reduced.

We will use Victorian retailers' cost data as a cross check of our benchmark

To support our decision for the 2020 VDO and cross-check our benchmark, in September 2019 we collected cost data from all retailers for the 2017-18 financial year. This data indicated that while costs varied significantly between retailers our benchmark represented an allowance for efficient retail costs across the industry. Our analysis did not suggest that our benchmark was particularly skewed towards either larger or smaller retailers. In particular, we are not convinced by statements from some retailers that the allowance should be higher to account for Victoria's competitive market, which is counterintuitive where a range of their competitors (of varying size and structure) are able to achieve lower costs.

We intend to update our data set by collecting cost data for the 2018-19 financial year from retailers. Collecting another year of data will provide further evidence on whether our benchmark approach continues to represent a reasonable estimate of efficient costs. We intend to collect this information using our information gathering powers under section 37 of the ESC Act. We plan on issuing the notices in late June with responses due in August. Being mindful of the regulatory cost of providing the data, we have already taken steps which we consider will reduce the cost incurred by retailers of responding to our cost data request. For example where possible, we have aligned data items requested with the information already collected by the Australian Competition and Consumer Commission. We have also engaged with different retailers to help streamline the request and make it easier to understand.

Although we aim to streamline our cost data request, we do not propose to change our approach to using the data. The pricing order does not require us to base our estimate of efficient costs on the actual costs of a retailer. Focusing on the costs of one group or individual retailer's costs in one particular year will not represent the longer term efficient costs of providing retail electricity services in Victoria. We plan to look at where our benchmark sits within the spread of costs across retailers while also considering differences in retailers' size, structure and approaches to classifying costs.

Although we propose to continue to use retailers' cost data as a cross check of our benchmark, we seek stakeholder views on the type of analysis we should conduct with it and how it can support our decision making.

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comprehensive review of retail operating costs in 2013, reporting an allowance of $110 per customer in 2012–13 prices. The IPART benchmark has also been historically adopted in regulated prices in Queensland and Tasmania.

We seek information on the impact of COVID-19 on retail operating costs

Since making our 2020 determination COVID-19 has caused major changes across the economy. This includes changes to the way in which retailers deliver their services and an increasing number of customers who face difficulty affording essential goods and services, including electricity. While we do not propose to make major changes to our overall approach or the how we use data from retailers, we do encourage stakeholder to provide evidence of the impact of COVID-19.

We understand that COVID-19 has had significant impacts on both businesses and consumers. We seek feedback on changes in the cost to serve and how those changes will impact customers.

While we will continue to monitor the impact of COVID-19 and encourage stakeholders to submit evidence on it, we have some preliminary observations. Anecdotally, we understand that some retailers have taken actions to offset increases in retail operating costs associated with COVID-19. These actions include reallocating current staff to priority areas or making adjustments to their marketing. When retailers present evidence of increases in specific costs, we would expect them to also provide of evidence of how their total costs to serve have changed. While some retail costs may have gone up, we would also expect these changes to be balanced by efficiencies in other retail costs, decreased wholesale prices and any deferral of network charges. We would also expect information on whether any overall increases are temporary or will lead to higher costs on an ongoing basis.

Questions for stakeholders

- What impact has COVID-19 had on retail operating costs and for how long will it effect costs?
- What approaches if any should we use to quantify the impacts (including any opposing changes)?

Customer acquisition and retention costs

The order requires us to include a modest allowance for customer acquisition and retention costs in making our VDO price determination. These costs include the cost of acquisition channels (such as third-party comparison websites or telemarketing), the cost of retention teams, and marketing costs targeted at driving customer acquisition or retention.

In our final decision, the commission proposed to estimate a modest allowance for customer acquisition and retention costs using a benchmarking approach based on cost levels from recent regulatory decisions, findings from the Australian Competition and Consumer Commission’s Retail Electricity Pricing Inquiry final report and information from retailers on their reported costs. This approach was relatively well accepted by stakeholders, with most feedback focusing on the level of the benchmark rather than the method of estimation.

For the 2021 VDO price review we propose to retain this benchmarking approach to setting an allowance for customer acquisition and retention costs (adjusted for inflation).

Retail operating margin

The pricing order requires us to have regard to retail operating margin when making a VDO price determination. Retail operating margin represents the operating profit margin required by investors to justify their financial investment in an electricity retail service. It should be enough to cover the cost of capital, and the systematic (non-diversifiable) risk associated with investment. 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, and that the commission is not required to base retail operating margins on actual retailer operating margins. In our final decision on the VDO commencing 1 January 2020, we made an allowance for a retail operating margin based on a benchmarking approach using recent regulatory decisions by Australian regulators.

For the review of the 2021 VDO price, barring any strong new evidence, we propose to keep the same benchmarking approach to setting an allowance for retail operating margin.

While we are not proposing to alter our approach to setting an allowance for retail operating margin, we are aware that COVID-19 will have an effect on the finances of both retailers and their customers.

Impact of the retail margin on competition

Submissions we received from retailers during our 2020 VDO review stated that the retail operating margin set in the last price determination was not high enough and could negatively affect retail competition and efficiency.

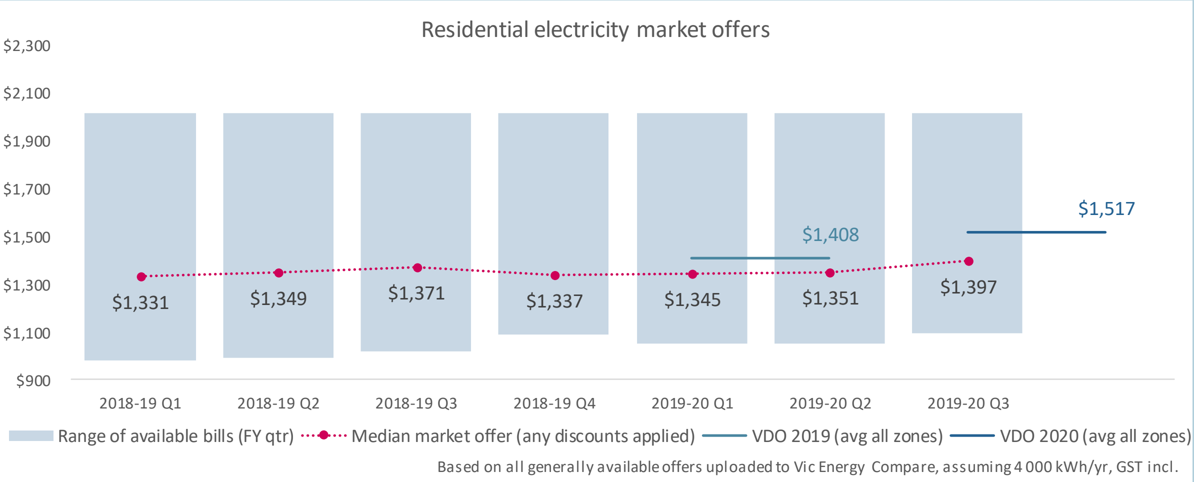
New retailers continue to emerge

The number of retailers continues to grow. Evidence of this is that during the 2019-20 financial year we granted one retail electricity licence and we have received 14 applications for retail licences.

Retailers still provide market offers at prices below the VDO

We have also observed how VDO prices compare to the market offers currently available from retailers. In the period 1 July to 31 December 2019, VDO prices were close to the median offer in each distribution zone. Figure 2 shows that when the VDO prices were updated in 2020 a gap appeared between the median market offer and the VDO. This gap shows that the annual bill based on the median market offer falls below the VDO annual bill.

Figure 2: Annual residential VDO bill compared to market offer bills (4,000 kWh/year)



We observe a similar pattern in the data for small business customers.

Customers are still looking for better offers

We also note that data from the Australian Energy Market Operator on residential and small businesses customers in Victoria shows that prior to COVID-19 the volume of customers transferring between retailers each month was still high.

Although the number of transfers decreased between March 2018 and March 2020, there was a downward trend in customer transfer volumes in Victoria for roughly 12 months before the first VDO price determination (mid-2018) when small customer churn reached a peak of over 90,000 transfers a month.[20] This peak is likely to have been driven by the Victorian Government's Power Savings Bonus.

We also note that the volume of customers changing retailers decreases in April 2020. This appears to coincide with government measures associated with COVID-19. We will monitor this and investigate further if the decrease in transfers is not temporary.

[20] AEMO, National electricity market monthly retail transfer statistics, April 2020, p.1.

Calculating the VDO tariffs and maximum bill

Once we have determined the cost of providing a retail electricity service, we turn the costs into prices for the Victorian Default Offer (VDO) using two different methods:

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

For our first determination we were required to use a maximum bill to regulate standing offers with non-flat tariffs. This is no longer a requirement: we can adopt another approach if it better serves the objective of the VDO.

Although we could change our approach to non-flat tariffs, for the 2021 VDO, we propose to continue to use VDO flat tariffs and the maximum bill. We are interested in stakeholders' views on these approaches, but we would need strong new evidence to change our position.

Flat VDO tariffs

Our VDO determination sets standing offer rates for flat tariffs. To set these rates, we must first identify the appropriate structure for these tariffs and how costs should be allocated within that structure.

Tariff structure

As in our previous VDO determination, our approach to tariff structure is 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 electricity retail market.

Considering this objective, we propose that it is best satisfied by setting VDO tariffs with a daily supply charge, a flat, anytime usage charge, and a controlled load charge for domestic customers as in previous VDO regulatory periods. This is largely due to the relative complexity and variety of non-flat tariff structures.

Unlike a flat, anytime usage charge, non-flat tariffs have different rates depending on the time of day when you use energy. This design is intended to send price signals to the customer that using energy during times of peak demand is more expensive and so incentivises them to reduce how much energy they use at these times or shift their usage into off-peak times of the day. However, the trade-off of these price signals is that they add complexity.

Time varying tariffs require the customer to have a clear understanding of their own usage pattern, and how it is reflected in their bill when it arrives. In the context of customers who are unwilling or unable to engage in the electricity retail market, it is likely this trade-off will dampen or entirely prevent the intended benefits of these price signals and negate the objective to provide a safeguard for these customers via a simple and trusted offer.

Another issue is the variety of different non-flat tariff structures. 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. Setting VDO tariffs for even a small number of these non-flat variations appears contrary to the objective of the VDO to be a simple and trusted offer available to safeguard customers who are unwilling or unable to engage in the electricity retail market.

Cost allocation

In our previous VDO price determination, we allocated fixed costs to the daily supply charge component and any costs that vary with consumption to the variable, per kilowatt hour charge component of the VDO price. We propose to remain consistent with this approach as a simple, logical method to allocate fixed and variable costs:

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)

Usage charge (variable costs) =

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

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

Questions for stakeholders on the flat VDO tariffs

- Are there other options for setting non-flat tariffs that would fulfil the objective of the VDO?
- Are there alternative approaches to allocating per day and per kilowatt hour charges that would better suit the objective of the VDO?
- Are there any other matters we should consider when allocating fixed and variable costs?

Maximum bill

In addition to setting the flat tariffs described above, our last decision also regulated standing offers with other structures (for example time of use and demand tariffs). We did this through setting a maximum bill amount based on the flat VDO tariffs at a representative customer usage.

Retailers choosing to offer non-flat standing offer tariffs were required to ensure that their tariffs would not result in a bill above the maximum at that usage amount. We took this approach as we considered it best met our obligations in the pricing order.

Taking this approach extended the safeguard of the VDO to all standing offer customers without removing the option of non-flat tariffs from customers currently receiving them. As noted above, our decision also stated that we thought a flat tariff structure for the VDO best met the objective to provide a simple, trusted and reasonably priced offer available to safeguard customers who are unwilling or unable to engage in the electricity retail market.

While our first determination required the use of a maximum bill to regulate non-flat standing offer tariffs, future decisions allow the commission to decide on the best approach. In line with our overall approach to setting the next VDO, we consider there is benefit in limiting the amount of change from our first determination to provide consistency for customers and retailers and allow time to review take-up of the different types of VDO's. During the pandemic consistency is likely to have added benefit. For this reason, our preliminary view is to retain the maximum bill to regulate non-flat standing offers. We would need strong new evidence to change our approach.

However, we are seeking feedback from stakeholders to ensure that this approach continues to provide an appropriate safeguard for customers while meeting our statutory obligations. We are particularly interested in any evidence that customers are choosing to take up non-flat standing offers and observations from stakeholders about their experiences with comparing these offers with the maximum bill amount.

Questions for stakeholders

- What other options should we consider for regulating non-flat standing offer tariffs and why?
- How many standing offer customers have chosen to take up a non-flat standing offer in the past 12 months?
- How many standing offer customers were placed on a non-flat standing offer in the past 12 months?
- Are there any changes we should consider to the way retailers are required to show that their non-flat standing offer tariffs comply with our determination?

Other considerations

Length of the regulatory period

The pricing order sets out that the regulatory period for a Victorian Default Offer (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. The commission must consult with the Minister for Energy, Environment and Climate Change before changing the length of the regulatory period.

In our advice to government on the first VDO prices, we recommended that they apply for six months to align with new network tariffs coming into effect on 1 January 2020. At that time, a new network determination was scheduled to be made by the Australian Energy Regulator from 1 January 2021.

Network pricing time periods are changing to financial years

The Victorian Government has signalled its intent to align Victorian network businesses with other jurisdictions and run on a financial year basis. In response to this, the Australian Energy Regulator has set out an approach for Victorian network businesses to cover the period from 1 January to 30 June 2021 before the new five-year determination comes into effect from 1 July 2021. This means that while we are likely to know the level of network costs for the first half of 2021 when making our 2021 VDO price determination, the network costs for the second half of 2021 would not be approved until later in 2021.

As network costs make up a significant component of VDO cost stack (between 35 and 43 per cent for residential customers), 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 simply allow retailers to pass through these costs to customers.

There are a number of ways we could address this proposed change in the regulatory period for the VDO.

We could change the length of our 2021 VDO determination

Consistent with our advice to government in May 2019, we could seek to adjust our regulatory period to align with changes in network tariffs. The first option to doing this would be to set VDO prices for six months from 1 January until 30 June 2021. A new 12-month determination would then be made in May 2021 for the period of 1 July 2021 to 30 June 2022. This option has the benefits of allowing us to base our determination on the most up to date information. It would also allow us to adjust for any significant and unexpected changes in costs that might take place due to

COVID-19. However, there would be an increased burden for both the commission and stakeholders from the need for a third VDO determination in two years.

A variant of this would be to make a VDO determination for 18 months from 1 January 2020 until 30 June 2021. Taking this approach would require the commission to base future network costs on a draft decision published by the Australian Energy Regulator. It would mean the commission would also need to forecast all other cost components for an extra six months, which may require an adjustment in the approach in some circumstances. While this approach reduces the burden of multiple determinations, there is a risk that we may need to amend the VDO determination on 1 July 2021 if the final determination for network businesses is materially different to the draft decision.

Another benefit of these two options is that a determination that finished on 30 June 2022 would align with the review of the operation and effectiveness of the VDO pricing order by 30 May 2022.[21]

We could defer changes until the 2022 VDO determination

Finally, the commission could choose to make no change to the length of the regulatory period. As with the 18 month option, this would require the commission to base network costs for the second half of 2021 on the Australian Energy Regulator's draft decisions for Victorian network businesses and may increase the chance of an amendment being required. It would also mean that we would need to consider this issue (i.e. the misalignment of the VDO and network price changes) when setting the VDO for 2022. However, there would likely be fewer changes to other aspects of the VDO determination.

We are interested in stakeholder views on how we should consider any changes to the VDO price determination period and approaches to weighing the benefits and costs of the options outlined. We are also seeking feedback on the relative benefit costs associated with the different options outlined (6, 12 or 18 months), and if there are other approaches that we should consider in making our decision.

Questions for stakeholders

- Should the commission change the length of the regulatory period beginning 1 January 2021 to 6 or 18 months? If so, what are the reasons for why we should make this change?

[21] Clause 17 of the order.

Cost data collection

In 2019, we collected data from retailers setting out the costs they faced in 2017-18 against each element of the VDO cost stack to better inform our 2020 VDO price determination. This data provided useful insight 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.

Although, at this stage, the data on its own is not enough to use for benchmarking, it will have value as a longitudinal data set to inform VDO decision making. This data is also an important cross check to ensure that our VDO cost stack reflects the efficient costs of the sale of electricity by retailers. We consider that these benefits outweigh the cost of collecting the data. As a result, we intend to issue a similar request to licensed electricity retailers for 2018-19 cost data in June this year.

We will take steps to reduce the cost associated with providing data

We recognise all businesses are experiencing uncertainty and significant challenges brought about by COVID-19. To understand the challenges retailers are facing we have already begun discussions with some retailers on the cost data request.

To minimise the regulatory burden on retailers, we propose to maintain consistency with the data fields captured in our previous cost data request and allow more time for retailers to compile this information. In addition, we will provide further guidance about how our data fields align with information the Australian Competition and Consumer Commission has previously requested from most retailers. We will also have staff available to explain the data collection fields to reduce the time it will take for retailers to understand the request.

We are also aware that retailers are providing data on other aspects of the energy market during this period of uncertainty. For many retailers, this is both in Victoria and other jurisdictions as well. We are committed to co-ordinating within the commission and with other regulatory bodies to minimise reporting burden where possible in this regard.

In our cost data request last year, we encountered some issues with reconciliation of cost element totals, units of input cost figures, and minor inconsistencies in reported metrics. We have identified improvements to our cost data template to help mitigate these issues and streamline reporting.

Questions for stakeholders

- Are there any other matters we should consider in the context of making a cost data request this year?

Variation mechanism

The existing variation mechanism allows for changes to the VDO if there is an unforeseen and material change in costs. While we consider that the variation mechanism contained in our current VDO determination is fit for purpose, we seek feedback from stakeholders on its operation including in the context of COVID-19.

Variation mechanisms in the pricing order

The pricing order provides that before or during a regulatory period, we may, on our own initiative, vary a VDO price determination in respect of the regulatory period.[22] However, we must specify, in the VDO price determination, the circumstances under which we will consider, and the basis in 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 may vary a VDO price determination:

- 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
- to correct a clerical error, miscalculation, misdescription or other deficiency.

The variation mechanism in our determination on the 2020 VDO

The commission included a mechanism that provides for variations to the VDO price determination in the event of a material unforeseen change or error that:

- was sufficiently uncertain or unforeseen at the time of making the price determination – such as an exogenous shock, and
- is sufficiently material to impact the benchmark established for the efficient costs of supply of an electricity retail service. [23]

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

Variation mechanism for our 2021 VDO determination

In its final decision on the Default Market Offer (DMO) for financial year 2021, the Australian Energy Regulator[24] noted (with reference to the impact of COVID-19) 'that given the current

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

[23] ESC, Victorian Default Offer Price Determination 2020: 1 January 2020 – 31 December 2020, 18 November 2019, clause 6.2.

[24] The Australian Energy Regulator regulates prices for standing offers in New South Wales, Queensland and New South Wales through the DMO. The DMO plays a similar role in those states to the role the VDO plays in Victoria.

uncertainties over future costs, there is merit in considering introducing a re-opener provision in the Regulations governing the DMO.'[25]

A variation mechanism, based on the one in our 2020 determination, could be used to vary our 2021 VDO determination if there are unforeseen changes in costs associated with COVID-19 during 2021.

We would only use the variation mechanism if, at the total cost level, the impact was material. Stakeholders should note that the use of a variation mechanism would apply to both material increases in costs and material decreases in cost.

The process for varying a determination can take months to complete. If stakeholders were concerned that a variation may be required, another way to deal with any uncertainty could be to make the regulatory period for the next VDO six months, instead of a year, as discussed in the section above on the length of regulatory period.

Questions for stakeholders

- Would the variation provisions similar to those in our 2020 VDO determination be suitable for dealing with unforeseen changes in costs associated with COVID-19 that take place in 2021?
- If not what changes to the variation mechanism should we consider?

[25] AER, Final Determination: Default Market Offer Prices 2020-21, 30 April 2020, p. 22. The AER also noted 'that any amendments to the Regulations are ultimately a decision for the Commonwealth Government.'