

Victorian Default Offer to apply from 1 January 2020

Draft decision

20 September 2019

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Summary

We have made a draft decision on our price determination for the Victorian Default Offer

This paper sets out the Essential Services Commission's draft decision on the methodology and approach for the Victorian Default Offer (VDO), covering retail electricity services. On 30 May 2019, the Victorian Government issued an Order in Council which required us to make a price determination to regulate retailers' standing offer tariffs for the sale of electricity to domestic and small business customers from 1 January 2020.¹

Our draft decision has considered feedback from stakeholders, including views raised in submissions responding to our issues paper, and at a workshop.²

Our draft decision would mean that annual electricity bills for customers on flat standing offer tariffs would slightly increase, due to increases in wholesale and network costs

A typical domestic customer on a flat tariff standing offer would, on average, see their annual electricity bill slightly increase. Based on 4,000 kWh annual consumption, the average bill increase across all distribution zones is 1.3 per cent, when compared with the VDO that applies from 1 July 2019 to 31 December 2019.

A typical small business customer on a flat tariff standing offer would, on average, see their annual electricity bill slightly increase. Based on 20,000 kWh annual consumption, the average bill increase across all distribution zones is 1.7 per cent, when compared with the VDO that applies from 1 July 2019 to 31 December 2019.

We note the bill increases are around inflation. The overall increase is driven by increases in wholesale and network costs, which are partly offset by reductions in environmental costs.

We have estimated the price for the VDO using a cost-based approach

We have used a cost-based approach to estimate the VDO, as it transparently sets out each of the costs included in calculating the VDO. It addresses the requirements of the order, which states the standing offer tariffs we determine are to be based on the efficient costs for the sale of electricity to domestic and small business customers. Moreover, it is an approach that has been used by a range of other economic regulators when setting electricity prices.

¹ Domestic and small business customers means customers who purchase power for personal, household or domestic use, or consume no more than 40 megawatt hours (MWh) in a year for business use.

² The Victorian Default Offer 2020: Issues Paper was released on 23 July 2019, and is available at www.esc.vic.gov.au. The public forum was held on 27 August 2019.

Our draft decision separately estimates costs for:

- wholesale electricity costs
- network costs (including metering)
- environmental scheme costs
- retail operating costs
- customer acquisition and retention costs
- retail margin
- other costs (e.g. regulatory and license fees, ancillary charges)

We have calculated VDO flat tariff prices based on our cost stack approach

We have calculated flat standing offer tariffs for each distribution zone and for domestic (including a controlled load option) and small business customers. Differences in VDO tariff prices reflect different wholesale and network costs incurred by retailers in each network distribution zone and between customer types. VDO flat tariff standing offers are calculated based on estimates of efficient costs according to our cost-based approach.

We are also required to set a compliant maximum annual bill for non-flat standing offers

The order requires us to determine the maximum annual electricity bill for standing offer customers who are on standing offer tariffs that are not flat or any combination of a flat and non-flat tariff. This means from 1 January 2020 the VDO price determination will cover all standing offers, including those based on time-of-use, demand, and flexible tariff structures.

We have calculated the VDO compliant maximum annual bill at a single representative level of annual consumption as we believe this best meets our statutory requirements. Our draft decision is to set the representative customer's usage at 4,000 kilowatt hours (kWh) for domestic customers and 20,000 kWh for small business customers.

We are seeking feedback before we make our final decision

This paper provides a further opportunity for stakeholders to provide feedback before we make our final decision and determination by 25 November 2019.

Submissions should be made by 17 October 2019 through Engage Victoria or by mail. Section 1.3 provides further details about how you can provide feedback.

Summary of Draft decision

Approach to estimating wholesale costs

The commission proposes to use a futures market approach based on the following inputs:

- AEMO MRIM data for the period 1 July 2016 to 30 June 2019. Data is split between domestic and small business customers with consumption less than 40 MWh per annum.
- National Electricity Market (NEM) spot price data for Victoria in the period 1 July 2016 to 30 June 2019.
- Taking the median price outcome from a Monte Carlo simulation producing 500 simulated forecasts of the year 2020 using the data above.
- ASX Energy contract prices for base and peak swaps, and \$300 caps for the 12 months up to 16 August 2019. Contract prices are the 12-month trade-weighted average.
- Minimised risk contract position, purchasing swaps to approximately cover average demand and caps to cover peak demand and incurring a small amount of pool exposure.
- Including a volatility allowance to reflect the cost of holding working capital to cover the small amount of pool exposure.

Approach to calculating network losses

The commission proposes to use data available from the AEMO for distribution loss factors and marginal loss factors.

Approach to estimating network costs

The commission proposes to:

- Directly include the simplest network use of service (NUOS) tariff in each distribution zone in the VDO – generally a daily supply charge and a flat usage charge.
- Where applicable for a particular domestic customer, the VDO should include a controlled load or dedicated circuit option.
- Include Advanced Metering Infrastructure charges for each distribution zone as a cost per customer.

Approach to estimating environmental costs

The commission proposes to make allowances for environmental costs using the following methods:

- LRET – the 2020 Default RPP is multiplied by the futures market price for large-scale certificates.
- SRES – the 2020 non-binding STP is multiplied by the clearing house price.
- VEU – the 2019 greenhouse reduction rate for electricity is multiplied by the historic 12-month average price for VEECs. To be updated once the 2020 reduction rate is set.

The LRET, SRES and VEU costs are multiplied by network loss factors.

- FiT (social cost of carbon) – total renewable exports in 2018-19 divided by average total domestic and small business customers in 2017-18 (to be updated for the final decision), multiplied by the social cost of carbon (2.5 cents).

Approach to estimating other regulatory costs

The commission proposes to make allowances for other regulatory costs using the following methods:

- 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 18 August 2019) of ancillary service payments based on AEMO data.
- RERT – based on the latest historic estimates of charges released by AEMO.
- ESC licence fees – market wide average of fees paid in 2017-18, adjusted for inflation. Our final decision will be updated if new information becomes available.

Approach to estimating retail operating costs

The commission proposes to make an allowance for retail operating costs of \$134, based on a benchmarking approach.

Approach to estimating customer acquisition and retention costs

The commission proposes to make a modest allowance for customer acquisition and retention costs of \$38, based on a benchmarking approach.

Approach to estimating retail operating margin

The commission proposes to make an allowance for retail operating margin using a benchmarking based on the most recent regulatory decisions from other Australian regulators.

Approach to varying a VDO price determination

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

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

We may also make a variation to a VDO price determination to correct a clerical error, miscalculation, misdescription or other deficiency.

Approach to the VDO compliant maximum annual bill

The commission proposes to set the VDO compliant maximum annual bill based on the flat standing offer tariffs we determine, and a representative usage profile for the customer group.

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

Retailers must publish all standing offers for the regulatory period beginning 1 January 2020 (including the flat standing offers we determine) in the Government Gazette in the period 25 November to 18 December 2019.

- If offering a flexible, five or seven-day time of use (or the 5-day time of day/9pm off peak) standing offer tariff, a retailer must demonstrate those tariffs do not exceed the relevant VDO compliant maximum annual bill using the approach detailed in Schedule 3 of the order (replicated in table 12).
- For any other non-flat standing offer tariff, a retailer must demonstrate that these tariffs do not exceed the relevant maximum annual bill by using a representative usage profile reflecting an estimate of consumption for that group of customers in the 12-month period beginning 1 January 2020. This usage profile must be submitted to the commission when the retailer publishes these standing offer tariffs in the Government Gazette.

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1. Introduction

The Victorian Default Offer (VDO) commenced on 1 July 2019. Based on advice prepared by the commission³ the Victorian Government in an Order in Council⁴ specified maximum prices retailers may charge for electricity standing offer contracts with a flat tariff structure. A flat tariff structure generally refers to charges that comprise a daily supply charge and a single usage charge calculated on a per kWh basis.⁵ The majority of standing offers comprise flat tariffs.⁶

Domestic and small business customers on a flat tariff standing offer consuming less than 40 megawatt hours (MWh) of electricity per year started receiving the VDO tariffs from electricity retailers on 1 July 2019.⁷ The VDO is also generally available to other domestic and small business customers receiving market or standing offers.

The introduction of the VDO generally resulted in reduced bills for customers on flat tariff standing offers. Noting impacts vary depending on a customer's electricity use, distribution zone, and the prices they were charged under pre-existing contracts, our advice estimated domestic customers using 4,000 kWh of electricity per year could save between \$310 to \$450 on their annual electricity bill when compared to the median standing offer prices. For a representative small business using 20,000 kWh of electricity per year, we estimated annual savings of around \$1,380 to \$2,050 compared with the median standing offer price in each distribution zone.⁸

Current VDO prices apply until 31 December 2019. The order requires us to make a VDO price determination under the *Essential Services Commission Act 2001* (Vic) (ESC Act) specifying the

³ Essential Services Commission, Victorian Default Offer to apply from 1 July 2019: Advice to Victorian Government, May 2019.

⁴ Governor in Council 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).

⁵ As defined in clause 4 of the order, a flat tariff means a tariff for the supply or sale of electricity where the tariff components do not vary by reference to: (a) the time of day; (b) the amount of electricity distributed or supplied during the day; (c) temperature, whether actual or forecast; or (d) other characteristics that vary during the day. The Victorian Default Offer also includes a component for controlled load tariffs, where applicable.

⁶ Based on the latest data we have available, approximately five per cent of domestic and 16 per cent of small business customers are on standing offers.

⁷ Domestic customer means a customer who purchases electricity principally for personal, household or domestic use at a supply point. Small business customer means a customer who is not a domestic customer and whose aggregate consumption of electricity taken from a supply point is not, or in the case of a new supply point not likely to be, more than 40 MWh per annum. These definitions are consistent with clause 4 of the order. Note that this excludes customers served by an exempt seller in embedded networks.

⁸ Consistent with our advice, the order specified separate Victorian Default Offer prices for domestic and small business customers.

standing offer pricing arrangements to apply from 1 January 2020. The order requires us to issue the VDO price determination by 25 November 2019.⁹

1.1. Victorian Default Offer pricing framework

As specified in the order, the objective of the VDO is to provide a simple, trusted and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the electricity retail market.¹⁰

Over the period from 1 July 2019 to 31 December 2019, the VDO only covers standing offers with a flat tariff structure. From 1 January 2020 the VDO price determination will cover all standing offers, including those based on time-of-use, demand, and flexible tariff structures for example. The duration of the regulatory period for our VDO price determination is 12 months, although this may be extended or reduced if special circumstances exist.¹¹ For each of the five electricity distribution zones in Victoria, the order requires the commission to determine:¹²

- 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 non-flat tariffs or tariffs that comprise any 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 need to consider a number of matters

In making our VDO price determination, the order requires the commission to adopt an approach and methodology that best meets the objectives of:¹³

- the Victorian Default Offer
- the ESC Act, and
- the *Electricity Industry Act 2000* (Vic) (EI Act).

⁹ Clause 10(1) of the order specifies that we must make the determination at least 37 days before the commencement of a regulatory period.

¹⁰ Clause 3 of the order sets out the objective of the VDO.

¹¹ Clause 11 of the order states that any change to the length of the regulatory period must be decided prior to the beginning of the regulatory period and after consultation with the Minister.

¹² Clause 10(2)(a) of the order.

¹³ Clause 12(1) and 12(2) of the order.

Further, the VDO price determination must be based on the efficient costs of the sale of electricity by a retailer¹⁴, having regard to:

- wholesale electricity costs
- network costs
- environmental costs
- retail operating costs, including modest costs of customer acquisition and retention¹⁵
- retail operating margin¹⁶
- any other costs, matters or things we consider appropriate or relevant.

The order also specifies that we must not include headroom.¹⁷ The VDO compliant maximum annual bill (covering standing offers with a non-flat tariff structure) must be based on the VDO tariffs applying to standing offers with a flat tariff structure, as well as the domestic and small business customer's electricity usage.¹⁸

1.2. Issues paper and consultation so far

On 23 July 2019, we released an issues paper outlining our initial views on the methodology and processes that we will follow to make our determination.¹⁹ We received 17 submissions in response to the issues paper. Commission staff also ran a workshop on 27 August 2019 providing stakeholders with an opportunity to provide us with further feedback. Our draft decision has considered all feedback received from stakeholders. A list of submissions received is provided at Attachment B.

1.3. Providing feedback to our draft decision

We invite stakeholders to make submissions in response to this draft decision.

Submissions should be made by **17 October 2019**. We may place lower weight on, or might not even be able to consider, submissions received after this deadline.

¹⁴ Clause 12(8) of the order does not require the commission to determine tariffs based on the actual costs of a retailer.

¹⁵ Clause 12(6) of the order instructs the commission to determine an allowance for modest costs of customer acquisition and retention.

¹⁶ 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 provides that the commission is not required to determine tariffs based on the actual retail operating margin of a retailer.

¹⁷ Clause 12(10) of the order, headroom means an allowance that does not reflect an efficient cost borne by firms operating in the market.

¹⁸ Clause 12(5) of the order.

¹⁹ Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, July 2019.

To make a submission on this paper please go to Engage Victoria's website:

<https://engage.vic.gov.au/>

Submissions can also be sent by mail to:

Victorian Default Offer 2020 price determination
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.

1.4. Timelines

Proposed milestones and timeline are set out below:

Key milestones	Indicative date
Draft decision released	20 September 2019
Draft decision forum	Early to mid-October
Submissions on draft decision due	17 October 2019
Final decision and determination	By 25 November 2019
Publication and gazettal of retailer standing offer tariffs ²⁰	25 November-18 December 2019

1.5. Structure of draft decision

From here, our draft decision is set out as follows:

- Chapter two summarises how we have interpreted our statutory requirements.

²⁰ As set out in clause 2(b) of the Ministerial Order dated 22 May 2019, published in the Victorian Government Gazette No. S 208 on Thursday 30 May 2019.

- Chapter three outlines our proposed approach to estimating the efficient costs of the sale of electricity by a retailer.
- Chapter four covers the calculation of flat tariffs for each distribution zone and indicative changes to the VDO flat tariffs.
- Chapter five describes our proposed approach to determining the VDO compliant maximum annual bill.

Our draft decision does not include figures for VDO tariffs and the compliant maximum annual bill. We have taken this approach as many of the variables impacting the VDO such as wholesale electricity costs, and network costs, are based on market data or tariffs approved by other regulators that are likely to change between the draft and final decisions.

However, as identified in the summary section (above) we have sought to provide an indication of the direction of changes and set out our methodology for calculating the VDO.

2. Addressing our statutory requirements

As noted in chapter 1, the order²¹ sets out many requirements and matters we must have regard to in making a VDO price determination. This chapter explains at a high level, how we have sought to address the statutory requirements.

In making a VDO price determination we must adopt an approach and methodology that is in accordance with section 33(2) of the ESC Act and the order.²² Taken together, this means we must adopt an approach and methodology that best meets the objectives of the ESC Act, the commission's objectives under the EI Act and the objective of the VDO.

The objective of the commission under the ESC Act is to promote the long term interests of Victorian consumers, having regard to the price, quality and reliability of essential services.²³ We consider the objective of the Victorian Default Offer – to provide a simple, trusted and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the electricity retail market – is consistent with promoting the long term interests of consumers.²⁴

In terms of quality and reliability of services, retailers are required to offer the VDO under the regulated terms and conditions for standard retail contracts. We expect therefore, that the quality of service experienced by customers will at least continue to meet these regulated terms and conditions.

The order requires the tariffs determined by the commission pursuant to the VDO price determination to be based on the efficient costs of the sale of electricity by a retailer. As well as supporting a reasonably priced electricity option we consider that determining tariffs based on efficient costs is consistent with promoting the long term interests of consumers.

We have sought to adopt an approach and methodology that ensures any benchmarks for efficient costs are sustainable and support the provision of retail services to customers. The methodology we have adopted considers key costs and risks associated with the provision of electricity retail

²¹ Governor in Council 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).

²² Clause 12(1) of the order.

²³ Section 8 of the ESC Act.

²⁴ The development of the VDO stemmed from the Independent Review into the Electricity and Gas Retail Markets in Victoria. The final report from the Independent Review recommended a range of regulatory responses were required to protect the long-term interests of consumers. See Independent Review into the Electricity and Gas Retail Markets in Victoria: Final Report, August 2017, p. 52.

services and provides for a retail operating margin. In doing so, we have had regard to the financial viability and efficiency of the industry, and incentives for long term investment.

In relation to the objectives of the EI Act we consider that a simple, trusted and reasonably priced electricity option based on efficient costs will promote protections for customers, including those facing payment difficulties. In terms of promoting the development of full retail competition, the VDO does not prevent customers from choosing their electricity retailer. Further, electricity retailers may offer different terms and conditions through market contracts, allowing for differentiation and competition based on price or service quality.

The EI Act also includes an objective for the commission to promote a consistent regulatory approach between the electricity and gas industries. Given there is currently no framework for the regulation of prices for retail gas services and as such we consider that this decision cannot offend that objective.

As noted in chapter 1, from 1 January 2020 our price determination framework will include a VDO compliant maximum annual bill. In determining the compliant maximum annual bill, we have had regard to the objective of the VDO to be a simple option and sought to provide for a framework that has regard to administrative costs and ease of understanding by customers. As with other elements of our methodology, we have also had regard to the approaches adopted by other regulators including the Australian Energy Regulator's (AER) Default Market Offer.

Clause 12(4)(f) of the order provides that in considering efficient costs, the commission may consider any other costs to those identified in the order, or other matters or things the commission, in the exercise of its discretion, considers appropriate or relevant.

We note that in many instances, our draft decision considers the commission's May 2019 advice to government on the VDO, and the feedback received from stakeholders in the development of the advice. In some cases, our draft decision adopts the same or a similar approach to that recommended in our advice to Government. Our draft decision expressly notes where this is the case. We consider that consistency in approach can support stability, certainty and trust in a regulatory approach, noting there is a need to allow for variation and flexibility to respond to new information or changing circumstances where justified, having regard to our statutory objectives.

While the purpose of our issues paper was to receive feedback from stakeholders on our initial views on the methodology and the processes we will follow in making a VDO price determination, some submissions included other broader observations.

In general, this feedback relates to the impact the VDO may have more broadly in the Victorian retail electricity market. AGL and ERM Power raised the possibility of VDO tariffs over time

becoming the highest priced electricity offer in the market.²⁵ The VDO price determination regulates only standing offer tariffs, which apply to only a small proportion of all customers. For the vast majority of customers, retailers are free to make different tariffs available to customers (either above or below the VDO) through market offers. amaysim suggested that the approach to making a VDO price determination was overly focused on retailers of particular size or structure.²⁶ Origin pointed to decreased churn rates as an indication that the VDO is undermining competition.²⁷

As highlighted in the discussion above, we are required to make our VDO price determination according to many specific statutory requirements. We have taken this feedback into account in making this draft decision, and weighed it against the requirements of the order to make a price determination that is based on the efficient costs of the sale of electricity by a retailer.

²⁵ AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 1;

ERM Power, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

²⁶ amaysim, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 1.

²⁷ Origin Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 1.

2. Addressing our statutory requirements

3. Approach and methodology for making a Victorian Default Offer price determination

The methodology we have proposed for our draft decision includes the determination of 10 flat standing offer tariffs, with a domestic and small business flat tariff VDO applying in each of Victoria's five distribution zones.²⁸ This approach is consistent with the May 2019 advice we provided government.

As outlined in chapter 1, the order requires that tariffs determined by the commission pursuant to the VDO price determination are to be based on the efficient costs of the sale of electricity by a retailer. This chapter sets out the approach we have taken to considering efficient costs and reflecting these in our VDO price determination. How these efficient costs are reflected in VDO flat tariff standing offers and the approach to determining the VDO compliant maximum annual bill are discussed in chapters four and five, respectively.

Informed by our May 2019 advice to government, our issues paper noted a cost-based approach best meets the objective of the VDO, has regard to the matters outlined in the order, and meets the objectives of the *Essential Services Commission Act 2001* (ESC Act) and *Electricity Industry Act 2000* (EI Act).²⁹ Most submissions did not comment on the use of a cost-based approach, instead focusing on the estimation of particular costs.

We consider the cost-based approach is a more transparent and replicable methodology than alternatives such as an index-based approach. Further, the cost-based approach is a well-established and accepted methodology used by other economic regulators when setting electricity prices. This includes the Australian Energy Regulator (AER) when setting network tariffs, the Independent Competition and Regulatory Commission (ICRC) in the ACT, and the Independent Pricing and Regulatory Tribunal (IPART) in NSW. In the United Kingdom, the Office of Gas and Electricity Markets uses a cost-based approach to set a default tariff cap.

A cost-based approach means we directly consider the main costs borne by electricity retailers, facilitating consideration of the financial viability of the industry under section 8A(b) of the ESC Act. In assessing efficient costs and providing for a retail operating margin, we have considered the incentives for long term investment under section 8A(a) of the ESC Act. A cost-based approach is also transparent, allowing stakeholders to see that we have not included an allowance for headroom consistent with the requirements of the order.

²⁸ Noting a component for controlled load applies to domestic customers, where appropriate.

²⁹ Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, July 2019, p. 7.

Pursuant to clause 12(4) of the order, the commission has included the elements in figure 1 to calculate the efficient costs of the sale of electricity by a retailer. This includes:

- wholesale electricity costs – including hedging costs and network losses for electricity
- network costs – which are directly taken from revenue determinations by the AER
- environmental costs – including national renewable energy schemes and the Victorian Energy Upgrades program
- retail operating costs, including modest costs of customer acquisition and retention
- other costs – such as licence fees and Australian Energy Market Operator (AEMO) fees
- retail operating margin – which is applied to all underlying costs.

Some elements of the cost-stack are calculated using market data such as wholesale electricity purchase costs. We will update estimates of these elements as close as possible to making our final decision and VDO price determination to account for any changes in market data.

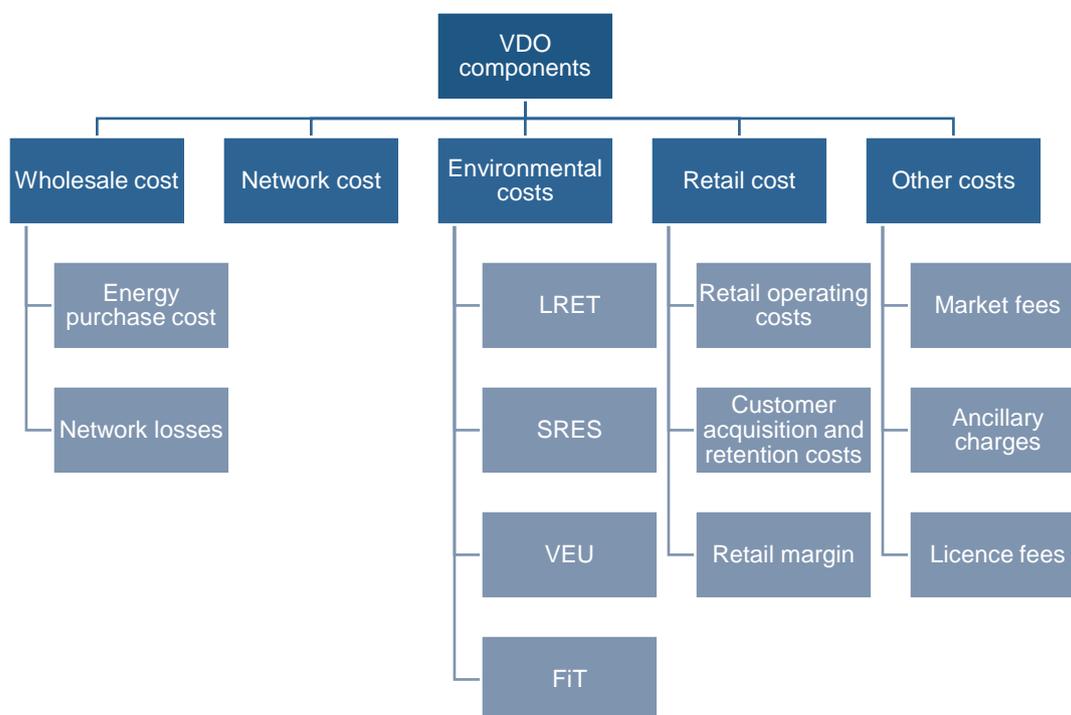


Figure 1 VDO components for retailing electricity

Our final decision and determination will also be informed by data we have requested from retailers.³⁰ The data requests seek cost information across all elements of the cost-stack, with more detailed information sought on retail costs. The data was not available prior to release of our

³⁰ The commission issued written notices pursuant to section 37 of the ESC Act to all Victorian electricity retailers to obtain this data.

draft decision and we do not propose to use this data to take a different approach to what is proposed in this draft decision. However, it will inform our consideration of feedback to our draft decision as we develop our final decision and VDO price determination.

3.1. Wholesale electricity costs

In making a VDO price determination, the order requires we have regard to the efficient costs of providing retail electricity services, including wholesale electricity purchases.³¹ Retailers purchase electricity from the wholesale market to meet the demand of their customers. While wholesale electricity costs can be volatile, retail prices can be unchanged for a relatively long period. This creates risk for electricity retailers. The volatility in the spot price³² can be managed by retailers in a variety of ways that include entering into arrangements where the wholesale price they will pay for electricity is set in advance. Often referred to as hedging, this arrangement can be achieved either by contracting directly with a generator, by owning generation assets, or through the derivative futures market, namely the Australian Securities Exchange (ASX Energy).

Issues paper proposal on wholesale electricity costs

Our issues paper signalled our intent to use a futures market approach, which is based on an estimate of the costs that a retailer would face in supplying electricity to their customers, having regard to the cost of financial hedging products purchased on ASX Energy. In particular, the approach is based on a forecast of the expected profile of consumption load and prices that a retailer is likely to face in the regulatory period, and the prices for different electricity futures contracts. Wholesale electricity purchase costs are calculated based on these inputs, taking an approach that minimises exposure to volatile high price wholesale spot price events.

Our issues paper also noted that where possible we would update our forecast for the latest available data.

Stakeholder feedback to our issues paper on wholesale electricity costs

Stakeholders provided a variety of feedback in response to our issues paper. Some retailer submissions either did not support the approach outlined in our issues paper or requested further

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

³² Supply and demand for wholesale electricity is matched in the National Electricity Market, which creates a price every 30 minutes. This spot price is used to settle financial transactions between producers and consumers of electricity in each region of the national market.

clarity on the approach.³³ Particular comments related to the transparency of modelling and accounting for volatility faced by retailers. These issues are discussed further below.

Consumer Action Law Centre (CALC) proposed that where the allowance for wholesale electricity costs was above actual wholesale costs over the course of the regulatory period, customers should be refunded.³⁴

Some retailers supported our proposed approach.³⁵ For example, AGL stated:

'AGL generally supported the futures market approach used by Frontier Economics (Frontier) to provide an estimate of wholesale electricity costs for the VDO from 1 July 2019 and therefore is supportive of the ESC maintaining a consistent approach for the 2020 VDO'.³⁶

Transparency

Some stakeholders raised concerns with the transparency of modelling, focusing on Frontier Economics' use of a Monte Carlo simulation to generate half-hourly prices and load data, and the contract optimisation model (*STRIKE*) in the preparation of our May 2019 advice to Government. Stakeholders submitted they would appreciate the opportunity to better understand the assumptions that support our approach. The Australian Energy Council (AEC) stated that:

'...we would encourage the ESC to undertake additional assessments, utilising alternative approaches to Frontier's "black box" approach. Undertaking an alternative, more readily

³³ For example, The Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p.1;

Powershop, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p.2;

Red Energy and Lumo Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p.3;

amaysim, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p.1;

ERM Power, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p.1.

³⁴ Consumer Action Law Centre, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 6.

³⁵ Momentum Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 1;

AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 1.

³⁶ AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 1.

accepted and transparent approach would provide industry confidence that Frontier's result is a reasonable estimate of accepted costs'.³⁷

Red and Lumo Energy stated:

'We welcome the Commission's commitment to work with stakeholders so we can better understand its approach to estimating wholesale costs and more specifically, the workings of Frontier's STRIKE model. The assumptions in this model - about risk management strategies, for example - are opaque so we welcome the chance to better understand whether they align with actual retailer behaviour and strategies'.³⁸

In response to stakeholder comments, we have published the supporting spreadsheets used by Frontier Economics on our website for stakeholders to review. These spreadsheets, which form the basis of the calculated wholesale electricity cost component for the VDO, detail the contract positions and settlement calculations, as well as the load and price profiles that are produced for the median simulated year as part of the Monte Carlo simulation. We have also published Frontier Economics' supporting report on our website.

Hedging

ERM Power asked us to contemplate the methods smaller and new entrant retailers take to minimise residual volumetric risk. They suggested smaller retailers may require other products such as 'load following hedges' to minimise risk, which it claims come at a premium to the forward price.³⁹

In developing a benchmark for wholesale electricity purchases, we have considered contract prices that are likely to reflect the market's view about future prices for 2020. ASX Energy base and peak swaps, and base \$300 caps prices are published for each contract for each trading day. In contrast, other contracts (such as load following contracts) lack transparency as their costs are not easy to verify, and these products are likely to reflect the actual costs of particular retailers that purchase these products, rather than the efficient cost in the market.

³⁷ The Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

³⁸ Red Energy and Lumo Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3.

³⁹ ERM Power, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

Volatility

Several stakeholders raised the issue of volatility in wholesale prices, particularly given the instability experienced during summer 2018-19. We note that AEMO anticipates tight supply for summer 2019-20⁴⁰, which is reflected in a submission by Simply Energy.⁴¹ Powershop recommended we include the most recent consumption and load data available, to reflect the changing risk of increased hedging costs.⁴² In calculating a price and load forecast, Frontier Economics has incorporated data for the three years ending 30 June 2019 (including summer 2018-19). It is our view that utilising three years of data to generate a simulated year (rather than just the most recent year) results in a forecast that is less exposed to the events of a specific year. This also provides methodological stability.

On the specific allowance provided for volatility, we note that the AEC supported the continued provision of a volatility allowance, following the recommended approach in our May 2019 advice to government.⁴³ Alinta suggested that given the number of different customer consumption profiles, we should provide an appropriate volatility allowance.⁴⁴ As a result of including the most recent data into the proposed approach the volatility allowance has increased when compared with the amount we proposed in our May 2019 advice to government.

amaysim posited that our approach to calculating costs is heavily weighted towards vertically integrated retailers (a retailer with generation capacity) who are naturally hedged against market volatility. Its submission proposed that the commission should therefore tailor the cost stack toward tier-two retailers.⁴⁵

Our draft decision on estimating wholesale electricity costs

Our draft decision is to use the futures market method to estimate wholesale electricity costs for the VDO to apply from 1 January 2020. We believe this approach is consistent with requirements under the order and the ESC Act.

⁴⁰ Australian Energy Market Operator, Electricity Statement of Opportunities, August 2019, p. 3.

⁴¹ Simply Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

⁴² Powershop, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

⁴³ Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

⁴⁴ Alinta, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 7.

⁴⁵ amaysim, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

The focus of our approach is to make an allowance for the efficient cost for the sale of electricity by a retailer. By basing our approach on transparent, market based data it reflects an estimate of the efficient wholesale purchase costs of a retailer, which does not require the retailer to be of a certain size or structure⁴⁶, and reflects the market's current view about the level of wholesale prices in the regulatory period.⁴⁷ Further, in taking an approach that represents the efficient costs of a retailer that assumes minimal risk in its hedging strategy (discussed further in the section below), we have also had regard to financial viability of the Victorian retail electricity sector.⁴⁸ We note that other regulators have used the futures market method to estimate electricity costs including Queensland Competition Authority and ICRC (ACT).⁴⁹ We also note the proposed market based approach is consistent with the method adopted in our advice to government in May 2019, providing for consistency in approach.

Further, during the development of advice to the Victorian Government on the VDO tariffs to apply from 1 July 2019, we engaged in a thorough consultation process, particularly regarding wholesale electricity costs. Through that process we refined how the futures market approach was applied with input from many retailers. Our draft decision considers much of that input.

The commission engaged Frontier Economics to provide an estimate of wholesale electricity costs for the VDO to apply from 1 January 2020 based on the approach described below.⁵⁰ We have sought to use publicly available data to increase the transparency in our estimation of the VDO. Where this has not been possible, we have also published supporting spreadsheets on our website setting out details of half-hourly load and price forecasts, contract positions resulting from Frontier Economics' modelling, and calculations for determining our proposed wholesale electricity costs.

As stated in our issues paper, the futures market approach requires inputs for:

- The likely half-hourly customer load.
- The corresponding likely half-hourly spot prices.
- The cost of financial hedging contracts that retailers will face.
- The hedging position a retailer is likely to adopt.

⁴⁶ Section 12(3) of the order requires that the tariffs determined by the commission are to be based on the efficient costs of the sale of electricity, with section 12(8) noting that we are not required to determine tariffs based on the actual costs of a retailer.

⁴⁷ Clause 12(8) of the order.

⁴⁸ Section 8A(1)(b) of the ESC Act requires we have regard to the financial viability of the industry.

⁴⁹ Section 8A(1)(f) of the ESC Act requires we have regard to consistency in regulation between States and on a national basis.

For example, ACIL Allen, Queensland Competition Authority Estimated Energy Costs for 2019-20 Retail Tariffs: Draft Determination, February 2019, or ICRC, Issues Paper: Electricity model and methodology review 2018-19, May 2019.

⁵⁰ A copy of this report is available on our website www.esc.vic.gov.au.

3. Approach and methodology for making a Victorian Default Offer price determination

The following sections describe our approach to addressing these inputs.

Consumption load and spot price data

The estimation of wholesale electricity costs in our draft decision is based on data provided by the Australian Energy Market Operator (AEMO), as it is structured consistently across all distribution zones. AEMO has taken the original aggregated Manually Read Interval Meter (MRIM) data for each of the Victorian distribution zones, and filtered and split the data by domestic and small business customers with consumption less than 40 MWh per year.⁵¹ Consistent with our May 2019 advice to government, we propose to calculate wholesale electricity purchase costs separately for domestic and small business customers.

We have updated our data set to include the most recently available MRIM data for the period 1 July 2016 to 30 June 2019.⁵² We have combined consumption load data with historical spot price data available from AEMO for the Victorian regional reference price node in order to determine the relationship between load profile and spot prices.

A Monte Carlo simulation was then conducted generating 500 simulated years using the three years of available data. We take the simulated year that resulted in the median price outcome in order to minimise the impact of any particular year on results, representing a reasonable and unbiased benchmark load profile.

In response to stakeholder views relating to transparency, we have published spreadsheets that detail the load and price profiles that are produced for the median simulated year as part of the Monte Carlo simulation. This array of half-hourly prices and load is a random set of days drawn directly from the actual data for the period 1 July 2016 to 30 June 2019.

Futures purchasing time period and profile

We have calculated the level of future prices based on hedging contract prices from ASX Energy, which has three main types of quarterly electricity derivative contracts that are traded:

- Base swaps for each quarter – a contract to trade a fixed amount of electricity for a certain price at all times in a day.
- Peak swaps for each quarter – similar to a base load swap, but applies only during the peak time period (7am-10pm AEST weekdays, excluding public holidays).

⁵¹ 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.

⁵² Data prior to this period was not suitable for use due to changes in the way data was structured from 1 July 2016.

- Base \$300 caps for each quarter – a contract that provides an effective cap on wholesale market prices at \$300, for a fixed amount of electricity.

These contracts trade for up to four years in advance, and prices are published by ASX Energy for each trading day. We have calculated the level of future prices based on contract prices for each quarter from 1 January 2020 to 31 December 2020, which is consistent with the order requiring us to make a price determination for a 12-month regulatory period from 1 January 2020. The futures contract prices we use are a 12-month trade-weighted average up to 16 August 2019. This 12-month time period is consistent with the approach adopted in our May 2019 advice to government. We consider 12-months provides a reasonable benchmark amongst the range of approaches that have been proposed to the commission through our consultation on the VDO. This 12-month average will be updated for our final decision.

Contract position

Our draft decision is based on analysis conducted by Frontier Economics using their *STRIKE* model, which calculates a set of efficient contracting options (i.e. portfolio of baseload and peak swaps, and cap futures products) that deliver the lowest energy purchase cost for a given level of risk. We have estimated wholesale electricity costs based on a minimal risk strategy. This involves estimating the mix of hedging products that retailers would purchase and how much this would cost. In general, the contract position at this point involves:

- purchasing swaps to cover (approximately) average demand
- purchasing caps to cover (approximately) peak demand
- incurring a small amount of pool exposure at absolute peak demand times.

In reaching our draft decision we have considered the feedback provided by stakeholders relating to the transparency of the *STRIKE* model and alternative approaches to estimating how a retailer would purchase futures contracts. The *STRIKE* modelling, which accounts for the risk between the expected volatility of spot prices and customer load, is used to generate an efficient contract position.

Consistent with our May 2019 advice to government, we have published the supporting spreadsheets used by Frontier Economics on our website for stakeholders to review. These spreadsheets detail the contract positions and settlement calculations, which form the basis of the calculated wholesale electricity cost component for the VDO. We have also published Frontier Economics' supporting report on our website. This report notes that other approaches using a rule of thumb approach to developing contract positions deliver broadly similar results. However, we propose to continue using the estimates generated by Frontier Economics and their *STRIKE* model

as it is more flexible to changes to the profile of load and spot prices, which may not be the case under a rule of thumb.⁵³

Volatility allowance

Our draft decision includes an allowance for holding some working capital (cash) to fund spot market purchases. The cost of holding this working capital is known as a volatility allowance and has been calculated based on the cost of holding working capital to fund cash flow shortfalls that could arise under events where the wholesale electricity spot market experiences periods of very high prices.

Draft decision – approach to estimating wholesale costs

The commission proposes to use a futures market approach based on the following inputs:

- AEMO MRIM data for the period 1 July 2016 to 30 June 2019. Data is split between domestic and small business customers with consumption less than 40 MWh per annum.
- National Electricity Market (NEM) spot price data for Victoria in the period 1 July 2016 to 30 June 2019.
- Taking the median price outcome from a Monte Carlo simulation producing 500 simulated forecasts of the year 2020 using the data above.
- ASX Energy contract prices for base and peak swaps, and \$300 caps for the 12 months up to 16 August 2019. Contract prices are the 12-month trade-weighted average.
- Minimised risk contract position, purchasing swaps to approximately cover average demand and caps to cover peak demand and incurring a small amount of pool exposure.
- Including a volatility allowance to reflect the cost of holding working capital to cover the small amount of pool exposure.

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.

⁵³ Frontier Economics, Wholesale Electricity Costs – a report for the Essential Services Commission, September 2019, p. 41.

Our issues paper signalled our intention to use the latest available data published by AEMO on average distribution loss factors and marginal loss factors to estimate network losses. We received little feedback to our issues paper on network losses. However, amaysim indicated that network costs are different for customers on short and long transmission lines, given different distribution loss factors. They suggested that losses should be weighted by the number of customers on each type of line rather than using only short-line losses.⁵⁴ In the absence of other feedback on this matter and further detail on the type and scale of this impact we do not propose to change our approach.

Accordingly, our draft decision uses the latest AEMO data on average distribution loss factors which were published by AEMO on 28 June 2019.⁵⁵ We have used the distribution loss factors that apply to most small customers in a given network. Marginal loss factors represent the increase (or decrease) in loss that would occur in response to an incremental change in generation output or load demand from its current value. AEMO published updated final marginal loss factors on 21 June 2019.⁵⁶ Our draft decision uses these to calculate average loss factors for the transmission network for each distribution zone based on the location of each relevant node.

Multiplying these loss factors together gives the combined loss factor for each network. This number represents the required generation for customers to consume 1 unit of electricity.

This total loss factor is then multiplied by the customer volume to calculate the cost of the additional amount of wholesale electricity a retailer needs to purchase to service that customer.

Draft decision – approach to calculating network losses

The commission proposes to use data available from the AEMO for distribution loss factors and marginal loss factors.

3.2. Network costs

Network costs represent the costs of building, operating and expanding the electricity distribution and transmission networks. There are five electricity distribution zones across Victoria (see figure 2). Each of these zones has separate characteristics which determine their respective tariffs.

⁵⁴ amaysim, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

⁵⁵ Australian Energy Market Operator, Distribution Loss Factors for the 2019-20 Financial Year, June 2019, p. 13.

⁵⁶ Australian Energy Market Operator, Updated Regions and Marginal Loss Factors: FY 2019-20, June 2019, p. 27-29.

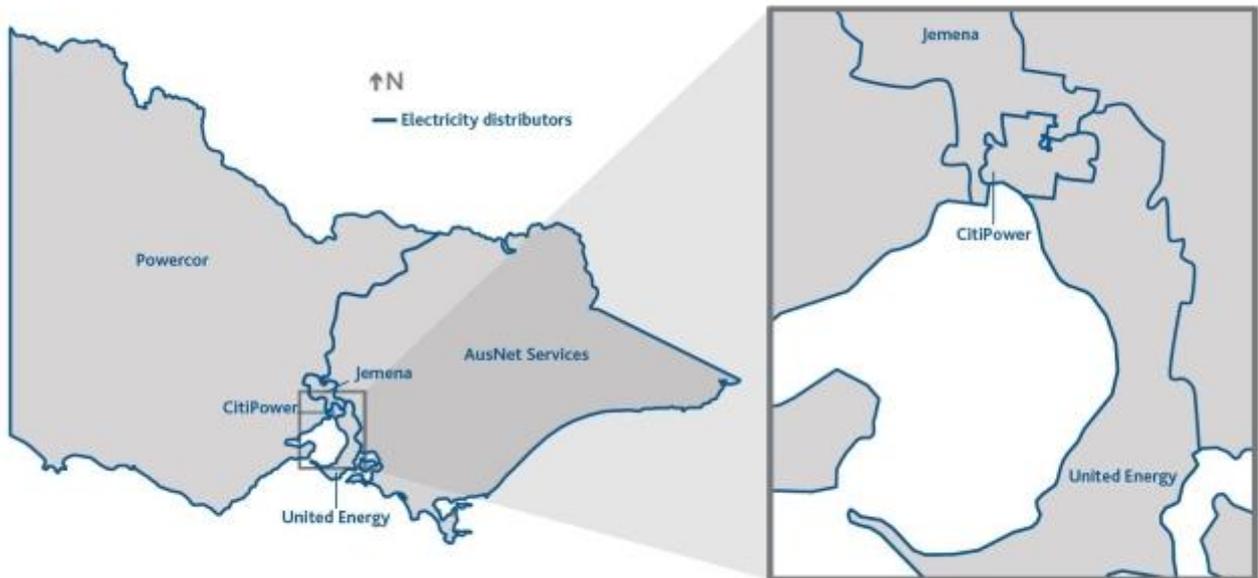


Figure 2 Map of Victorian electricity distribution zones

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

- Distribution charges – tariffs for the use of the distribution network.
- Transmission charges – tariffs for the use of the transmission network.
- Jurisdictional charges – tariffs for the payments distributors are required to make to customers as part of the Victorian Premium Feed-in Tariff.

These charges vary between the distribution businesses as each network has its own specific requirements in terms of maintenance, expansion and cost allocation.

The five electricity distribution businesses in Victoria were required to install Advanced Metering Infrastructure (i.e. smart meters) to small customers in their networks. To recover the cost of this rollout, the Australian Energy Regulator (AER) approves a regulated charge for smart meters on a per customer basis.

Issues paper proposal on network costs

In our issues paper we proposed to maintain the approach from our final advice to government in May 2019 for calculating network costs as well as Advance Metering Infrastructure costs, which were both treated as a cost pass through to customers. We also noted that we would incorporate the latest published tariff data in determining network costs, as approved by the AER.

Stakeholder feedback on network costs

Simply Energy suggested that the VDO rate should be adjusted for the greater network costs for serving higher intensity users with three-phase meters.⁵⁷ At this point it is unclear how relevant these costs are for the VDO, nor does it appear that tariffs are particularly targeted at this customer group. Without further data on this issue, we do not propose to make changes to our approach.

Responses to our issues paper raised no new objections to the general cost pass-through approach to determining network costs, but a number raised concerns about possible misalignments between network tariffs and the VDO flat tariffs in the context of the maximum annual bill. These issues are addressed in chapter 5.

Our draft decision on estimating network costs

Our proposed approach remains as outlined in our issues paper. We propose to maintain this approach for calculating network costs, using 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 AER will approve the 2020 tariff proposals for Victoria's electricity network (to commence 1 January 2020) later in 2019 and we will use the latest approved tariffs in our final decision. We also anticipate United Energy's LVS1R residential tariff and LVM1R small business tariff will be simplified by the removal of seasonality.⁵⁸

⁵⁷ Simply Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4.

⁵⁸ United Energy indicated its intention to simplify both tariffs from 1 January 2020 in a submission to our draft advice to government, available on our website at www.esc.vic.gov.au.

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/F200a/T200b
Powercor	Residential single rate, D1	Non-residential single rate, ND1
United Energy ⁵⁹	Low voltage small 1 rate, LVS1R	Low voltage medium 1 rate, LVM1R

Table 1 Network tariff categories

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

Table 2 Controlled load network tariff categories

Advanced Metering Infrastructure (AMI) charges

Our draft decision applies the relevant 2019 metering charges (updated for inflation) from each distribution zone to the relevant tariff for each electricity distribution zone. As proposed for other network charges, we propose to update charges, as approved by the AER, on a calendar year basis. Our final decision and determination will include the approved metering charges for 2020.

⁵⁹ Note: United Energy's 2019 tariffs include a seasonal element, which we have converted to a flat annual tariff.

Draft decision – approach to estimating network costs

The commission proposes to:

- Directly include the simplest network use of service (NUOS) tariff in each distribution zone in the VDO – generally a daily supply charge and a flat usage charge.
- Where applicable for a particular domestic customer, the VDO should include a controlled load or dedicated circuit option.
- Include Advanced Metering Infrastructure charges for each distribution zone as a cost per customer.

3.3. 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 approach to calculating the VDO has regard to environmental costs as an element in discerning the efficient costs of the sale of electricity by a retailer.⁶⁰

⁶⁰ Clause 12(4)(c) of the order.

Issues paper proposal on environmental scheme and other regulatory costs

Our July 2019 issues paper proposed to estimate environmental scheme costs based on market data and other publicly available data.⁶¹ For other regulatory costs we proposed basing them on publicly available information.

Stakeholder feedback on environmental scheme and other regulatory costs

Our proposed approach to estimating LRET scheme costs drew the majority of comment in relation to environmental costs in submissions to our issues paper.⁶² Other than this issue, stakeholders were either supportive or provided relatively little comment on our proposed approach to environmental costs. For example:

“AGL largely supports the approaches previously used by the ESC but considers that market-based approach is no longer appropriate for the estimation of the cost of the Large-scale renewable energy scheme.”⁶³

Large-scale Renewable Energy Target costs

Most submissions commenting on our proposed approach to estimating LRET costs questioned the appropriateness of a market-based method that is based on the market prices for trading Large-scale Generation Certificates.⁶⁴

- Some submissions suggested that large-scale certificate prices, as traded in futures markets, are not reflective of the investment a prudent retailer would have made to cover their environmental obligation.⁶⁵ These submissions claimed that the forecast cost of large-scale certificates is well below the Power Purchase Agreement (PPA) contracts retailers have in place, and a prudent and efficient retailer would have invested in PPAs to reduce their exposure

⁶¹ Essential Services Commission 2019, Victorian Default Offer to apply from 1 January 2020: Issues Paper, 23 July, p. 14.

⁶² For example, Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2;

amaysim, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

⁶³ AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 1.

⁶⁴ Note, a market-based approach involves using publicly available data of traded instruments in a liquid exchange to estimate costs of complying with environmental schemes.

⁶⁵ EnergyAustralia, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2-3.

to the market price for large-scale certificates.⁶⁶ One retailer noted the change in forecast price of large-scale certificates is the result of a policy position rather than from a market process.⁶⁷

- A separate submission proposed an alternative approach using a portfolio approach to estimate LRET costs, thereby accounting for the investment retailers have previously made in PPAs.⁶⁸

While we note this feedback from some stakeholders, we consider an approach based on market data remains appropriate. Large-scale certificate spot and forward prices are transparent and represent the most reliable indicator of the current market consensus view of the price of large-scale certificates. In addition, market prices represent efficient costs as they are the price at which the market currently trades these products. We believe this is efficient as a retailer is able to purchase certificates in this market.

In having regard to interstate approaches we have considered a report for the Queensland Competition Authority's electricity cost review 2019-20, prepared by ACIL Allen. This review noted large-scale certificate costs will decline due to the LRET not just being fully supplied but oversupplied.⁶⁹ The decline in large-scale certificate prices is a function of market conditions – reflecting not only the retail market, but also the appetite of larger customers to enter directly into contracts with renewable providers and some renewable generators taking on risk in the wholesale market.

In addition, data from renewable PPA contracts are often confidential and bespoke to the circumstances of a particular retailer rather than a more representative estimate across the industry. The order does not require us to consider the actual costs of a retailer. Further, the commission does not have information on the terms and conditions of those contracts meaning there are a number of reasons why they might differ from the efficient cost of complying with the LRET scheme. In contrast, the market price for large-scale certificates provides a transparent and verifiable way to estimate the cost of the LRET that is currently available to market participants to meet their obligations.

⁶⁶ Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

⁶⁷ EnergyAustralia, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2-3.

⁶⁸ Momentum Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 1.

⁶⁹ ACIL Allen, Queensland Competition Authority Estimated Energy Costs for 2019-20 Retail Tariffs: Draft Determination, February 2019, p. 8-9.

Our proposed market-based approach is consistent, internally (for example with our approach to wholesale electricity costs), with our previous advice on the VDO, and with decisions by other Australian regulators.⁷⁰

Regulatory timing differences – cost pass-through

Some submissions noted that the Clean Energy Regulator sets the binding Renewable Power Percentage (RPP) and the Small-scale Technology Percentage (STP), respectively relevant to estimating LRET and SRES costs, in March for the relevant calendar year.⁷¹ One submission queried how our approach would account for the potential over/under estimation of the STP and RPP.⁷²

We propose to use the default RPP to estimate LRET costs and the non-binding STP set by the Clean Energy Regulator to estimate SRES costs. These estimated obligations may differ from the binding percentages released by the Clean Energy Regulator in March 2020, but they are currently the best publicly available information. We intend to use a cost pass-through to account for any differences in our forecasts for RPP and STP.⁷³ While LRET and SRES costs are incurred by retailers, the level of costs for our price determination may differ from the actual obligation set for retailers in March. The cost pass-through ensures costs are updated to account for the final RPP and STP applicable for the relevant regulatory period and incorporates any under or over recovered amounts relating to LRET or SRES costs for 2020. As a result, we would update our second regulatory period VDO price determination to reflect any over or under-recovery associated with changes to renewable obligations in the 2020 VDO price determination. We do not propose to make a variation to account for these changes as it is unlikely to meet the requirements described in section 4.3. This is consistent with how other regulators have dealt with this timing mismatch.⁷⁴ If the final VEU greenhouse reduction rate for 2020 is not published before our final decision we may also propose a cost pass-through mechanism for these costs.

⁷⁰ For example: Queensland Competition Authority, Regulated retail electricity prices for 2019-20: Final determination, May 2019, p. 34.

⁷¹ For example, Powershop, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3;

Australian Energy Council, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

⁷² Red and Lumo Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3.

⁷³ Note, cost pass-through mechanisms are usually restricted to events that are outside the control of a regulated entity.

⁷⁴ For example, Queensland Competition Authority, Regulated retail electricity prices for 2019-20: Final determination, May 2019, p. 63-65;

Independent Pricing and Regulatory Tribunal, Review of Regulated Retail Prices for Electricity from 1 July 2013 to 30 June 2016: Final Report, June 2013, p. 82-83.

Retailer Reliability Obligation

Some submissions raised concerns we were not accounting for Retailer Reliability Obligation costs in our approach to environmental costs for the regulatory period beginning 1 January 2020.⁷⁵

One stakeholder referenced a regulatory impact statement on the Retailer Reliability Obligation from the Energy Security Board. As the overall impact for the policy showed a net benefit, without further clarity on the specific costs that are incurred by Victorian retailers we do not propose to make an allowance for these costs. Nonetheless, we plan to continue collecting cost data and will review any changes over time.

Our draft decision on estimating environmental costs and other regulatory costs

The proposed approach to estimating the costs for each of these schemes are outlined below.

Large-scale renewable energy target (LRET)

The LRET scheme operates through the creation of tradable certificates. One megawatt hour (MWh) of renewable energy generation from accredited power stations creates one certificate. The amount of renewable energy that must be generated each year is specified in the *Renewable Energy (Electricity) Act 2000* (Cth). An obligation is placed on electricity retailers to purchase and surrender a certain number of certificates each year to meet their renewable energy obligations.

To calculate the cost for retailers to comply with the LRET, the quantity of certificates a retailer must purchase and surrender is multiplied by the likely price of large-scale generation certificates (LGCs).

The Clean Energy Regulator determines the number of LGCs that must be purchased by retailers from renewable generators by 31 March each year. This percentage is known as the renewable power percentage (RPP).

Use of a market-based approach to estimate LRET costs is transparent and has regard to the efficient costs of the scheme. In addition, our approach is consistent with other Australian regulators who estimate LRET costs.

The binding RPP is not released until after our final decision and determination in November so we are unable to use the binding RPP for 2020. However, the Clean Energy Regulator provides a method to calculate a default RPP in the case they do not release the RPP by 31 March. We propose to use the default RPP in place of the binding RPP to calculate LRET costs for 2020.

⁷⁵ For example, Alinta Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3;

Powershop, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3.

In addition, this will be combined with a cost pass-through mechanism that will allow for any difference between the default RPP and binding RPP to be accounted for in future regulatory periods.

Analysis conducted by Frontier Economics for the commission estimates the cost of complying with the LRET. The market price for LGCs is determined by taking a volume-weighted average of LGC futures trades for 2020 reported by Demand Manager.⁷⁶ This 12-month average LGC price is \$45.13 per certificate.⁷⁷

This liability is also multiplied by network losses to reflect that the liability calculation is based on electricity purchases from AEMO settlement point at the Victorian regional reference node.

Small-scale renewable energy scheme (SRES)

The SRES places an obligation on retailers to purchase small-scale technology certificates. The Clean Energy Regulator sets the percentage of small-scale certificates to be purchased and surrendered each year, known as the small-scale Technology Percentage (STP).

Similar to the LRET, the cost of complying with the SRES is estimated by multiplying the quantity of small-scale certificates a retailer must surrender by the price a retailer is likely to pay for each certificate.

The STP is published for any given year by March 31 of that year. The Clean Energy Regulator also publishes non-binding estimates for the following two years.

The binding STP is not released until after our final decision and determination in November so we are unable to use the binding STP for 2020. We propose to use the non-binding STP for 2020 in place of the binding STP to calculate SRES costs.

In addition, this will be combined with a cost pass-through mechanism that will allow for any difference between the binding STP and the non-binding STP to be accounted for in the next regulatory period.

Liable entities can purchase small-scale certificates on the open market or through a certificate clearing house, where they are sold at a fixed price of \$40 per certificate. For the purposes of this decision we assume that the cost of small-scale certificates is equal to this clearing house price of

⁷⁶ Available at: <http://demandmanager.com.au/certificate-prices>. Accessed 12 September 2019.

⁷⁷ For more detail see Frontier Economics, Wholesale Electricity Costs for 2020: A report for the Essential Services Commission, September 2019, p. 48.

\$40.⁷⁸ Historically, the reported spot price of small-scale certificates has typically been at, or close to, this price of \$40.

Similar to the LRET, the STP applies to electricity acquired from the AEMO settlement point at the Victorian regional reference node. As such, the STP is also subject to electricity loss factors in our calculation of the VDO.

Victorian Energy Upgrades (VEU)

Under the VEU program, relevant entities (energy retailers) must surrender a number of Victorian Energy Efficiency Certificates (VEECs) equal to their scheme liability. If a relevant entity fails to surrender a sufficient number of certificates for a particular calendar year, it must pay a penalty per certificate by which it falls short. It is at the discretion of the relevant entity whether it creates certificates directly through energy saving activities, or whether it decides to purchase certificates from accredited businesses.

A retailer's annual electricity VEEC liability is calculated by multiplying its total liable electricity acquisition (in MWh) by the greenhouse gas reduction rate for electricity. For the 2020 compliance year (1 January to 31 December 2020) the reduction rate for electricity has not yet been gazetted. As such, our draft decision applies the 2019 greenhouse reduction rate. We plan to update our final decision with the 2020 greenhouse reduction rate.

We have relied on historic data purchased from the market monitoring service TFS Green and used a simple average of spot prices for the last 12 months. This involves rolling forward the cost of VEECs from previous years. Use of a market-based approach to estimate VEEC costs is transparent and has regard to the efficient costs of the scheme. We plan to replicate this approach going forward to ensure that any changes in prices are eventually reflected in the VDO.

The VEEC liability is also subject to electricity loss factors in our calculation of the VDO.

Feed in tariff (Victoria)

In Victoria, the commission is required under the *Electricity Industry Act 2000 (Vic)* to determine one or more rates that an electricity retailer must pay its customers for electricity they export to the grid, referred to as the minimum feed-in tariff (FiT).⁷⁹

The minimum FiT incorporates three components that represent costs a retailer avoids when a customer generates renewable electricity and supplies it into the network (wholesale costs, market fees and network losses). As such, there is no need to compensate retailers for these costs in the

⁷⁸ For more detail see Frontier Economics, Wholesale Electricity Costs for 2020: A report for the Essential Services Commission, September 2019, p. 49.

⁷⁹ See section 40FBB of the Electricity Industry Act 2000 (Vic).

VDO. A fourth component, the value of avoided social cost of carbon, is not an avoided cost to the retailer and therefore we assume it is recovered by retailers from the wider customer base.

We propose to estimate this additional cost based on the volume of rooftop renewable electricity exported to the grid, divided by the total number of small Victorian electricity customers.

There is limited data available on forecasts of distributed energy exports. As such, we intend to use historical data as the best available proxy.

We have received total renewable export data for small customers from each of the distribution businesses for 2018-19. We also collect customer number data via the Victorian Energy Market Report. The latest published data we have available on customer numbers is the average number of customers by retailer for 2017-18. We plan to update our final decision with customer numbers for 2018-19.

AEMO market fees

Market fees include charges for participating in the market, full retail contestability and AEMO's role as the national transmission planner. Estimates and forecasts of these costs are reported in AEMO's Energy Market Budget and Fees report. We have used an average of the 2019-20 budget fee and the 2020-21 estimate fee to calculate relevant charges for the VDO to apply from 1 January 2020.⁸⁰

Ancillary charges

Ancillary services are used by AEMO to manage the power system safely, securely and reliably, with respect to standards such as frequency, voltage and system restart processes. Unlike other AEMO charges, AEMO operates separate markets for various ancillary services. As such, the relevant charges are dependent on the amount of service required at any particular time, which means the costs will vary from period to period.

We have completed analysis of AEMO data to estimate Victorian ancillary charges in the regulatory period beginning 1 January 2020. We intend to use an average of the past 52 weeks (ending 18 August 2019) of ancillary service payments in Victoria, this results in an average ancillary service payment of \$0.30/MWh.

Reliability and Emergency Reserve Trader costs

The Reliability and Emergency Reserve Trader (RERT) is a function conferred on AEMO to maintain power system reliability and system security using reserve contracts. We are required to

⁸⁰ Australian Energy Market Operator, 2019-20 AEMO Final Budget and Fees, June 2019, p. 8.

have regard to the efficient costs of sale of electricity by a retailer which we have considered by including costs that are outside the control of a regulated entity.

We have included the latest cost data in the VDO. This means that the actual costs of the RERT are included in the VDO, rather than forecasts, which could either overstate the cost (if it is not required in a certain year) or understate the cost (if it is required on multiple occasions). However, we note that even if a retailer's customer numbers significantly change, the impact of our lagged estimate for these costs on the total VDO price will be small. We use publicly available data from AEMO which we consider is transparent.

Essential Services Commission licence fees

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

We propose to use a market wide average of all retailer licence fees in estimating the cost of a licence fee for the VDO. The latest available data on licence fees is from 2017-18, we will update these amounts for inflation. If newer data becomes available we will include this in our final decision.

Draft decision – approach to estimating environmental costs

The commission proposes to make allowances for environmental costs using the following methods:

- LRET – the 2020 Default RPP is multiplied by the futures market price for large-scale certificates.
- SRES – the 2020 non-binding STP is multiplied by the clearing house price.
- VEU – the 2019 greenhouse reduction rate for electricity is multiplied by the historic 12-month average price for VEECs. To be updated once the 2020 reduction rate is set.

The LRET, SRES and VEU costs are multiplied by network loss factors.

- FiT (social cost of carbon) – total renewable exports in 2018-19 divided by average total domestic and small business customers in 2017-18 (to be updated for the final decision), multiplied by the social cost of carbon (2.5 cents).

Draft decision – approach to estimating other regulatory costs

The commission proposes to make allowances for other regulatory costs using the following methods:

- 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 18 August 2019) of ancillary service payments based on AEMO data.
- RERT – based on the latest historic estimates of charges released by AEMO.
- ESC licence fees – market wide average of fees paid in 2017-18, adjusted for inflation. Our final decision will be updated if new information becomes available.

3.4. 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.

Clause 12(4)(d) of the order requires we have regard to retail operating costs, including modest customer acquisition and retention costs, as an element in developing the efficient costs of the sale of electricity by a retailer. We address customer acquisition and retention costs in section 3.5.

Issues paper

Our issues paper proposed a benchmarking approach to estimate efficient retail operating costs. In addition, our issues paper noted the intention to collect disaggregated cost data from retailers. The commission issued a request for information to all licensed retailers on 3 September 2019 to obtain information pertaining to the costs of supplying retail electricity.⁸¹

Stakeholder feedback on retail operating costs

Submissions provided relatively little comment on our issues paper proposal to adopt a benchmarking approach. Rather, submissions mostly commented on the level of potential benchmarks and identified factors that we should consider in estimating the benchmark.⁸² For

⁸¹ The commission made this request pursuant to section 37 of the ESC Act.

⁸² AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2;

Simply Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3;

Momentum Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

example, CALC suggested that regulatory changes should create efficiencies and lower costs.⁸³ Some retailers referenced additional regulatory costs for operating in Victoria which are not accounted for in historical benchmarks, including⁸⁴:

- increased expense from bad debt, and
- investment in staffing and systems to comply with regulatory changes.

Two submissions suggested our approach should consider adjustments to our benchmark as an incentive for efficiency in retail operating costs over time.⁸⁵

Our draft decision on estimating retail operating costs

We note that clause 12(4)(f) of the order provides that in considering efficient costs, we may consider any other costs, matters or things the Commission, in the exercise of its discretion, considers appropriate or relevant. Our previous advice to government, and the feedback we received during this process, is a matter we have considered.

Based on feedback to our issues paper, the benchmark approach appears to be relatively well accepted by stakeholders. We propose to estimate retail operating costs based on a benchmarking approach. This is consistent with the methodology we used in our advice to government.

On the level of the benchmark, our advice to government adopted the ICRC's 2017 retail operating costs decision of \$124 per customer. Recognising impacts of recent regulatory changes with the introduction of the payment difficulty framework and the analysis of Victorian specific costs in the ACCC's inquiry final report, we increased the ICRC benchmark by an additional \$10 per customer, noting this may reduce over time.

While some submissions responding to our issues paper commented on likely changes in costs, we received no new information that causes us to change our view that the benchmark established in our advice to government should change (other than updating the benchmark for inflation).

⁸³ For example, Consumer Action Law Centre, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 7.

⁸⁴ For example, amaysim submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3;

AGL, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3.

⁸⁵ Consumer Action Law Centre, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4;

Origin Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

We note that information we receive from electricity retailers in response to our information request will provide a cross-check of this benchmark and inform the retail operating cost benchmark we adopt for our final decision and determination.

In adopting this approach for our draft decision, we have had regard to efficiency and incentives for long term investment, and the financial viability of the industry. A benchmark approach provides incentives for retailers to pursue efficiencies because they may profit from those efficiencies.

Draft decision – approach to estimating retail operating costs

The commission proposes to make an allowance for retail operating costs of \$134, based on a benchmarking approach.

3.5. Customer acquisition and retention costs

The pricing order requires us to include a modest allowance for customer acquisition and retention costs (CARC) in making our VDO price determination. Our allowance reflects the costs of competing for customers in a contestable retail market. These costs include the cost of acquisition channels (such as 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.

Issues paper proposal on customer acquisition and retention costs

Our issues paper noted the analysis we had conducted in providing our final advice to government for the VDO in May 2019. In that advice, we recommended using a benchmarking approach to determine a modest allowance for customer acquisition and retention costs. 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.

The issues paper also noted that a formal request was under development to enable the collection of consistent data across all retailers that could be used as a cross check with any benchmarks.

Stakeholder feedback on customer acquisition and retention costs

The Consumer Action Law Centre submitted that a CARC allowance was not efficient or in the interests of households, especially for those customers who are disengaged or not looking to

switch retailers.⁸⁶ However, most submissions on this allowance from retailers provided feedback on the methodology and benchmarks used to derive it.

amaysim submitted that the estimate used in the final advice was out of date, and that more recent data from the ACCC inquiry final should be used.⁸⁷ Powershop submitted that the allowance should be based on 'current marketing standards and approaches' according to the terms of reference for the 1 July 2019 VDO.⁸⁸ Red and Lumo Energy submitted that a 'reasonable' CARC allowance was necessary to maintain competition, which promotes customer choice and improved customer service outcomes, and that more modest allowances will favour incumbents.⁸⁹

We note that retailers were generally supportive of the decision to request data from retailers. EnergyAustralia noted that these costs will increase with recent and upcoming interventions, including the payment difficulties framework and the VDO, which will take time to manifest in reported data.⁹⁰ Further, it noted that the level of expenditure by retailers will reflect the level of competition in Victoria, which it considers robust.

Our draft decision on estimating customer acquisition and retention costs

In coming to our proposed allowance for our draft decision, we have considered submissions from stakeholders, the economic basis and justification for CARC, and the requirements of the order. As with other elements of the cost stack, we have had regard to the benchmark and methodology recommended in our May 2019 advice to government.

Based on feedback to our issues paper, the benchmark approach appears to be relatively well accepted by stakeholders, with most feedback focused on the level of the benchmark. Therefore, we propose to estimate CARC based on a benchmarking approach. This is consistent with the methodology we used in our advice to government.

The order is clear that the allowance made for CARC is to be modest, and there is no requirement for it to be based on actual retailer costs. We have considered evidence that a situation has eventuated in which retailers spend increasing amounts in pursuit of the same pool of customers.

⁸⁶ Consumer Action Law Centre, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 8.

⁸⁷ amaysim, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3.

⁸⁸ Powershop, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3.

⁸⁹ Red and Lumo Energy, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3.

⁹⁰ EnergyAustralia, submission to the Essential Services Commission Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3-4.

In our May 2019 advice to government we noted the significant increase in CARC expenditure between 2013-14 and 2016-17⁹¹, which had occurred while customer switching in Victoria had remained relatively constant between 25 and 30 per cent.⁹² It also appears that some of this growing expenditure is on targeted one-off inducements to switch (e.g. gift cards) that are unlikely to be offered, or benefit, most consumers. In short, it does not appear that customers in aggregate are the primary beneficiaries from increased expenditure. In this context we have considered that the most recent data from Victoria is unlikely to represent a modest allowance.

Our proposed approach to estimating an allowance is to be based on a publicly available benchmark, as it is transparent and based on approaches taken by retailers in contestable markets. Our approach to benchmarking CARC considers:

- the provision made in a range of regulatory decisions in other jurisdictions
- the findings of the ACCC inquiry final report
- information from retailers on their reported costs.

We also considered feedback received from stakeholders and advice from Frontier Economics, who we previously engaged to analyse allowances for CARC as part of advice to government on the VDO to apply from 1 July 2019.

For these reasons, our draft decision for a modest allowance for CARC is based on the NEM-wide average for 2013-14 (adjusted for inflation) from the ACCC inquiry final report.⁹³ This decision is made on the basis that the 2013-14 data is the most robust data currently available that also limits the impact of the increased CARC expenditure observed in Victoria and across the NEM in recent years. In this context we consider our recommended allowance of \$38 accords with the requirements of the order – namely, that we provide a modest allowance.

To inform our VDO price determination we released a formal request for cost data to Victorian electricity retailers on 3 September 2019. This was foreshadowed in our final advice to government on the VDO and discussed in our issues paper. The request includes a section on cost categories for both domestic and small business customers. We may use this data as a cross check against the allowance calculated for this draft decision in preparation of the final decision. We will also consider the use of this data in future price determinations.

⁹¹ Essential Services Commission, Final advice to the Victorian Government on the Victorian Default Offer to apply from 1 July 2019, May 2019, p. 68.

⁹² Australian Energy Market Commission, 2019 Retail Energy Competition Review, June 2019, p. 103.

⁹³ ACCC, Retail Electricity Pricing Inquiry – Final Report, July 2018, p. 222.

Draft decision – approach to estimating customer acquisition and retention costs

The commission proposes to make a modest allowance for customer acquisition and retention costs of \$38, based on a benchmarking approach.

3.6. Retail operating margin

The order requires that in making a VDO price determination we have regard to retail operating margin.⁹⁴ 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.⁹⁵ The 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 margin⁹⁶, and that the commission is not required to base retail operating margins on actual retailer operating margins.⁹⁷

Our final advice on the VDO price to apply from 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.

Issues paper proposal on retail operating margin

Our issues paper proposed to continue using a benchmarking approach in estimating retail operating margin.⁹⁸

Stakeholder feedback on retail operating margin

Stakeholders provided feedback on the level, methodology, and broader impacts of the retail operating margin included in the VDO.

⁹⁴ Clause 12(4)(e) of the order.

⁹⁵ Non-diversifiable risks are considered to be unavoidable and are typically attributable to market factors that affect all firms.

⁹⁶ 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.

⁹⁷ Clause 12(9) of the order.

⁹⁸ 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 decision we are not proposing to explore alternatives at this time.

Most feedback related to the level of the retail operating margin in our advice to government in May 2019. Origin Energy reiterated views expressed in previous submissions for the VDO to apply from 1 July 2019 that the retail operating margin methodology does not adequately allow for increased market and regulatory risk, preferring the selection of a margin higher in the range considered.⁹⁹ Simply Energy similarly indicated that margins need to be able to cover increased risk in wholesale market volatility in recent years.¹⁰⁰ amaysim suggested that the retail operating margin should be higher to reflect the higher retail operating costs of tier-two retailers, who spend more on customer acquisition and the provision of customer service.¹⁰¹ CALC suggested that the commission should undertake bottom-up modelling of efficient retail margins, and select the low end of any range determined.¹⁰² We may consider whether this approach is appropriate for future reviews.

A number of submissions indicated concern with the broader effects of the retail operating margin. AGL suggested that implementing the VDO alongside energy market reforms in Victoria, including the clear advice entitlement, advance notice of changes that impact a customer's bill, and best offer notification, would result in the VDO price becoming a market price cap.¹⁰³ As a consequence, the allowed retail margin would become the maximum possible margin for retailers, with detrimental effects on competition and innovation. Powershop similarly noted that low operating margins would reduce incentives to improve product offerings and customer service, and would result in convergence of retail offerings.¹⁰⁴ Simply Energy suggested that further reductions in the operating margin would have a disproportionate effect on smaller retailers without generation assets to supplement revenue, reducing competition.¹⁰⁵

⁹⁹ Origin Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

¹⁰⁰ Simply Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 1.

¹⁰¹ amaysim, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4.

¹⁰² CALC, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 8-9.

¹⁰³ AGL, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3-4.

¹⁰⁴ Powershop, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3.

¹⁰⁵ Simply Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

3. Approach and methodology for making a Victorian Default Offer price determination

Active Utilities noted the margin allowed in the commission's advice to government on the VDO to apply from 1 July 2019 was reasonable for embedded network operators. It did however state that the commission should consider recent regulatory risks it believes are systematic risks.¹⁰⁶

Our draft decision on estimating the retail operating margin

For our draft decision on the retail operating margin, we have decided to continue to use a benchmark approach based on recent decisions by Australian energy regulators.

We note that submissions on the issues paper provided various reasons why current risks facing the sector might mean that a higher margin is required. However, we consider that the risks and costs identified are adequately accounted for in the individual components of the cost stack to which they relate.

Specific risks around wholesale market volatility are addressed in the wholesale energy cost component of the cost stack. We have not seen evidence to suggest that the systematic risks associated with wholesale costs (being the undiversifiable risks associated with the impact of general movements in economic indicators such as economic growth rates) have changed. In particular, we note that the retail operating margin is based on the systematic risks in the economy associated with operating in the retail electricity market, rather than being a provision for the business specific risks for individual retailers.

The costs of current (and new) regulatory obligations are covered in retail operating costs, which includes an allowance for costs specific to Victoria. However, we do recognise that other policy changes may result in outcomes that lower costs (e.g. banning door-knocking sales). We do not consider it appropriate to provide an adjustment to the retail operating margin to account for potential future regulatory changes.

A modest allowance is made for customer acquisition spending in the CARC cost category (noting that some stakeholders have argued that no allowance should be made), and costs of customer service are included in retail operating costs.

We may monitor suggestions that the retail operating margin for the VDO will have detrimental impacts on competition and customer service through our new workstream to review the competitiveness and efficiency of the market. However, we note that the methodology and selection of the retail operating margin is consistent with the order, having had regard to other interstate benchmarks. We have considered that to select a higher retail operating margin with the

¹⁰⁶ Active Utilities, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 10-13.

intention of improving retail competition would be akin to making an allowance for headroom and therefore contrary to the order.

Draft decision – approach to estimating retail operating margin

The commission proposes to make an allowance for retail operating margin using a benchmarking based on the most recent regulatory decisions from other Australian regulators.

4. Calculating the Victorian Default Offer price

This chapter discusses how we propose to calculate the VDO flat tariff standing offers based on estimates of efficient costs according to the approach outlined in chapter 3. Our discussion covers the allocation of costs to the different components of flat tariff standing offers (and controlled load for domestic customers).¹⁰⁷ Our price determination must also regulate standing offer tariffs for non-flat standing offer tariffs. This is dealt with in our approach to the maximum annual bill in chapter 5.

This chapter also summarises the changes in cost stack elements that have occurred since we provided advice to the government and their broad impact. Finally, it concludes by considering the circumstances under which we would consider making a variation to our price determination.

4.1. VDO tariff structure and cost allocation

To calculate the flat standing offer tariffs as part of our VDO price determination we need to allocate the fixed and variable costs discussed in chapter 3 between the daily supply charge and variable consumption charge. Our July 2019 issues paper indicated our intention to follow the same approach as our final advice to government for the VDO applied from 1 July 2019.

Under this approach, the VDO tariffs are comprised of a daily supply charge and a flat, anytime usage charge. The per kilowatt hour usage charge was aligned with the underlying single rate flat distribution network tariff, with the exception of AusNet Services distribution zone (where there is a specific rate for the first 1,020 kWh usage per quarter and another rate for any further electricity consumed). For domestic customers, a per kilowatt hour controlled load charge is also included. This approach aligns with the requirements of the order to determine flat tariff standing offers (and controlled load for domestic customers).

Within this structure, our issues paper proposed allocating fixed costs to the daily supply charge and variable costs to the per kilowatt hour charge.

Feedback from stakeholders

In response to our issues paper, submissions were largely supportive of our intention to use the same approach to tariff structure and cost allocation that we used in our final advice to

¹⁰⁷ Clause 10(2)(a)(i) of the order requires that in the first regulatory period the commission must determine the standing offer tariffs that are to apply in respect of flat tariffs, including, in the case of domestic customers, both flat tariffs and flat tariffs with a controlled load tariff.

government.¹⁰⁸ We received minimal additional feedback on how costs should be allocated or on the intended structure of the VDO tariffs required under the order. In addition, a number of submissions discussed our proposed approach to setting VDO tariffs for non-flat standing offers. This feedback was provided in response to the VDO compliant maximum annual bill and is discussed in chapter 5.

Our draft decision for tariff structure and cost allocation

Tariff structure

Noting stakeholder support for the approach our issues paper proposed, we intend to continue setting the VDO tariff structure as a daily supply charge and a flat, anytime usage charge. For domestic customers, this will also include a controlled load rate.

Our approach is guided by the objective of the order, which states the VDO is to provide a simple, trusted and reasonably priced option for customers unable or unwilling to engage in the market. Under the order, from 1 January 2020 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)

This approach also maintains consistency with our final advice to government for the VDO tariffs applied from 1 July 2019.

Cost allocation

As with tariff structure, considering support from stakeholders we propose to allocate fixed costs to the daily supply charge and apply any costs that vary with consumption to the per kilowatt charge.

¹⁰⁸ See for example; AGL, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p.6;

Simply Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p.3;

Alinta Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p.3;

Australian Energy Council, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p.3.

Daily supply charge (fixed costs) =

[*(retail operating costs)* + *(customer acquisition and retention costs)* + *(fixed network costs)*
+ *(FiT social cost of carbon)* + *(per customer other costs)*]

X

(1 + retail operating margin)

Usage charge (variable costs) =

[*(wholesale electricity costs)* + *(variable network costs)* + *(environmental program costs)*
+ *(per kWh other costs)* + *(electricity network losses)*]

X

(1 + retail operating margin)

We propose this approach on the basis that it is a simple and logical way to allocate costs within the VDO tariff structure and maintains consistency with our final advice to government for the VDO tariffs applied from 1 July 2019. We also believe it meets the requirement for the tariffs we determine to be based on the efficient costs for the sale of electricity by a retailer.

Calculating the cost stack components

To set the VDO tariffs, we calculate the components of the cost stack as either fixed amounts per year or variable amounts per kilowatt hour. Our proposed methodology to estimate these costs and stakeholder feedback are provided in chapter 3. Where necessary, we have indexed costs for inflation using the Australian Bureau of Statistics Consumer Price Index (All Groups, Original).

Wholesale electricity costs

We have engaged Frontier Economics to estimate wholesale electricity costs for 2020 using the method described in section 3.1. This methodology produces an estimate based on a 12-month trade weighted average of future contract prices, assuming hedging strategies that minimise the level of risk, and an allowance for volatility.

These costs vary across Victoria as a result of different customer load profiles in each distribution zone. Calendar year 2020 estimates of the wholesale electricity price and volatility allowance for each zone are displayed in the table below.

Distribution zone	Domestic		Small business	
	Wholesale price - 12 month (\$/MWh nominal)	Volatility allowance (\$/MWh nominal)	Wholesale price - 12 month (\$/MWh nominal)	Volatility allowance (\$/MWh nominal)
AusNet Services	\$108.95	\$0.35	\$102.75	\$0.28
CitiPower	\$106.01	\$0.35	\$105.63	\$0.35
Jemena	\$113.26	\$0.44	\$105.01	\$0.36
Powercor	\$107.77	\$0.37	\$101.79	\$0.25
United Energy	\$113.39	\$0.41	\$106.62	\$0.40

Table 3 Wholesale electricity forecasts for 2020, as at 16 August 2019 (GST exclusive)

Source: Frontier Economics, Wholesale electricity costs for 2020: a report for the Essential Services Commission, 2 September 2019, p. 40, 50.

Network losses

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

We have calculated the total loss factor based on the 2019-20 distribution and marginal loss factors published by AEMO.¹⁰⁹

Distribution zone	Distribution loss factor (DLF)	Marginal loss factor (MLF)	Total loss factor
AusNet Services	1.0583	0.9950	5.30%
CitiPower	1.0474	0.9975	4.48%
Jemena	1.0418	0.9984	4.01%
Powercor	1.0682	0.9795	4.63%
United Energy	1.0570	0.9959	5.26%

Table 4 Network losses

Source: AEMO

¹⁰⁹ Australian Energy Market Operator, Distribution Loss Factors for the 2019-20 Financial Year, June 2019, p. 13; and Australian Energy Market Operator, Updated Regions and Marginal Loss Factors: FY 2019-20, June 2019, p. 27-29.

4. Calculating the Victorian Default Offer price

Network costs

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

These charges are regulated by the AER and are approved towards the end of the calendar year period to apply in the following year. Due to this timing, our draft decision is based on the proposed 2020 network tariffs for domestic and small business customers that were proposed by distribution businesses as part of their 2019 tariff approvals. We have maintained 2019 metering costs for our draft decision (updated for inflation).

These charges are included in the tables below. We note, the final 2020 network tariff approvals will be made by the AER before we make our final decision and determination. Our final decision will include the final 2020 network tariffs and metering charges approved by the AER.

Distribution zone	Daily charge (\$ per year)	Variable charge structure	Variable charge (\$ per kWh)
AusNet Services	\$121.00	Block 1 (1020 kWh)	\$0.1051
		Block 2 (>1020 kWh)	\$0.1368
CitiPower	\$95.00	Anytime	\$0.0692
Jemena	\$58.95	Anytime	\$0.0839
Powercor	\$135.00	Anytime	\$0.0751
United Energy	\$46.03	Anytime	\$0.0864

Table 5 Domestic electricity network charges, 2020 (GST exclusive)

Source: Victorian distribution businesses' 2019 annual tariff statements

Distribution zone	Daily charge (\$ per year)	Variable charge structure	Variable charge (\$ per kWh)
AusNet Services	\$121.00	Block 1 (1020 kWh)	\$0.1469
		Block 2 (>1020 kWh)	\$0.1877
CitiPower	\$160.00	Anytime	\$0.0840
Jemena	\$120.43	Anytime	\$0.1047
Powercor	\$175.00	Anytime	\$0.0822
United Energy	\$64.61	Anytime	\$0.1023

Table 6 Small business electricity network charges, 2020 (GST exclusive)

Source: Victorian distribution businesses' 2019 annual tariff statements

Distribution zone	Annual metering charge (\$ per customer)
AusNet Services	\$57.80
CitiPower	\$73.00
Jemena	\$79.84
Powercor	\$73.00
United Energy	\$57.00

Table 7 Network metering charges, 2019 (GST exclusive)

Source: Victorian distribution businesses' 2019 annual tariff statements

Environmental scheme costs

Large-scale Renewable Energy Target (LRET) costs

Under the LRET scheme, the liability percentage is called the Renewable Power Percentage (RPP). The Clean Energy Regulator will not set the RPP for 2020 until March 2020. As an

4. Calculating the Victorian Default Offer price

alternative the Clean Energy Regulator provides an approach for calculating a default RPP. We have engaged Frontier Economics to estimate the cost of complying with the LRET. This includes estimating the default RPP for 2020 (20.15 per cent) and calculating the 12-month average of 2020 futures market prices for certificates (LGCs) as reported by Demand Manager.¹¹⁰ The resulting estimate is reported in table 8.

Small-scale Renewable Energy Scheme (SRES) costs

The liability percentage under the SRES scheme is called the Small-Scale Technology Percentage (STP). The Clean Energy Regulator does not publish the binding STP until March 2020. However, it has published the non-binding STP for 2020 at 14.56 per cent.¹¹¹

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

Victorian Energy Upgrades (VEU) costs

For the cost of complying with the VEU scheme, we use the relevant greenhouse reduction rate for electricity of the reference price year being assessed. The greenhouse reduction rate for 2020 has not yet been set so our draft decision uses the rate for the 2019 compliance year of 0.15419. We understand that the 2020 greenhouse reduction rate will be set prior to our final decision, which will be updated to include the 2020 rate. The cost of certificates under the VEU scheme (VEECs) is gathered from historic market prices. Based on currently available information, we estimate an average price of \$20.08 per certificate for 2020.

Cost of complying with Environmental Schemes (GST exclusive):

Environmental scheme	Certificate price	Scheme liability	Cost (\$/MWh)
LRET	\$45.13	20.15%	\$9.09
SRES	\$40.00	14.56%	\$5.82
VEU	\$20.08	15.42%	\$3.10

Table 8 Environmental program costs for 2020, (GST exclusive)

Source: Frontier Economics, Wholesale electricity costs for 2020: a report for the Essential Services Commission, 2 September 2019, p48-49.

¹¹⁰ Available at: <http://demandmanager.com.au/certificate-prices>. Accessed 12 September 2019.

¹¹¹ We note that there have historically been significant differences between the non-binding STP and the binding STP which we will account for through a cost pass-through mechanism.

4. Calculating the Victorian Default Offer price

Retail operating costs

We have described our benchmarking approach to retail costs and margin in chapter 3. These costs are fixed and apply equally across each distribution zone.

Retail costs

Based on the analysis in sections 3.4 and 3.5, we have selected an allowance of \$134 for retail operating costs and \$38 for customer acquisition and retention costs (see table 9).

Retail margin

Based on analysis in section 3.6, the commission proposes to apply a retail margin of 5.7 per cent. The retail margin represents the margin in dollars as a proportion of the total revenue.

Retail costs and margin	Annual allowance
Retail operating costs	\$134
Customer acquisition and retention costs	\$38
Retail margin	5.7%

Table 9 Retail costs and margin (GST exclusive)

Other costs

Retailers incur other costs through fees for market operations and ancillary services. Information about these costs has been gathered primarily from AEMO's Budget and Fees report.¹¹² The estimate of the commission's licence fee is a market-wide average based on the approved fees for the year 2017-18, updated for inflation.¹¹³ We have adopted a forecast of ancillary charges based on analysis of the past 12 months of ancillary service cost data. The impact of the social cost of carbon on retailer costs is based on total small-scale renewable exports in 2018-19 and customer numbers in 2017-18 (as discussed in section 3.3).

Charge	Rate
AEMO	
NEM market fees	\$0.53/MWh
Full retail contestability	\$0.08/MWh
National Transmission Planner	\$0.03/MWh
Energy Consumers Australia	\$0.52/customer
Ancillary services	\$0.30/MWh
RERT	\$3.22/customer
ESC licence fee	\$0.56/customer
Feed-in Tariff (social cost of carbon)	\$8.52/customer
Total per MWh \$0.94/MWh	
Total per customer \$12.82/customer	

Table 10 Other costs (GST exclusive)

¹¹² Australian Energy Market Operator, 2019-20 AEMO Final Budget and Fees, June 2019.

¹¹³ Our final decision will be updated with newer data if it is available.

4. Calculating the Victorian Default Offer price

4.2. Comparison to the current Victorian Default Offer tariffs

Since our final advice to government for the VDO to apply from 1 July 2019 to 31 December 2019, we have updated our estimates of different cost stack elements in this draft decision for the VDO to apply from 1 January 2020. This broadly reflects changes in the cost of wholesale electricity, environmental programs, and network charges.

Other elements that have affected underlying costs since our final advice to government include the volume of solar exports used to calculate the social cost of carbon under the minimum feed-in tariff, updated electricity network loss factors, and changes to ancillary fees and charges.

Overall, this represents an average increase of \$19 or 1.3% for a typical domestic customer (consuming 4,000 kWh per year) and \$105 or 1.7% for a typical small business customer (consuming 20,000 kWh per year).¹¹⁴ We note this is lower than forecast annual CPI increase of 1.8%.¹¹⁵

Cost components that have increased

Wholesale electricity and network costs both increased, contributing on average 1.3% (wholesale) and 1.4% (network) to the total increase in a typical domestic customer's average annual VDO bill. For small business customers, on average these costs accounted for 1.7% (wholesale) and 1.8% (network) of the overall average increase. As these components make up approximately 80% of costs in a typical customer's annual bill, these increases were the primary drivers of the overall increase in the cost stack.

Other costs, such as those related to solar exports and ancillary fees and charges, also increased. These changes had a less significant impact, contributing on average 0.1% and 0.02% of the total increase to the VDO cost stack for domestic and small business customers respectively.

Cost components that have decreased

Declining market prices for large scale renewable certificates meant that environmental scheme costs contributed a decrease to the average overall VDO cost stack of around 1.6% for domestic and 2% for small business customers. Typically, these costs contribute only five to seven per cent of a total annual bill for a typical customer. Because of this, this decrease has been outweighed by increasing wholesale electricity and network costs.

¹¹⁴ This represents the change to a typical domestic and small business customer bill averaged equally across all five distribution zones.

¹¹⁵ Reserve Bank of Australia, August 2019 Statement on Monetary Policy, forecast for the year to June 2020.

Component	Contribution to change for domestic customer		Contribution to change for small business customer		Reason for change
	\$	%	\$	%	
Wholesale	\$18	1.3%	\$96	1.7%	Higher futures market prices for 2020.
Network	\$19	1.4%	\$106	1.8%	Higher network charges forecast for 2020.
Environmental	-\$23	-1.6%	-\$114	-2.0%	Declining certificate prices for LRET in 2020.
Other	\$2	0.1%	\$1	0.02%	Increased volume of solar exports in 2018-19 and changes to ancillary fees.
Retail operating costs	-	-	-	-	No change.
Customer acquisition and retention costs	-	-	-	-	No change.
Retail margin	\$1	0.1%	\$5	0.1%	Consequential change due to increase in the overall VDO cost stack.
GST	\$2	0.1%	\$10	0.2%	Consequential change due to increase in the overall VDO cost stack.
Average total VDO bill change	\$19	1.3%	\$105	1.7%	

Table 11 Contribution to the average change in cost components of the VDO for an average annual bill (nominal, GST incl)

Note: these estimates are based on an annual bill based on the flat tariff VDO, averaged across the five distribution zones for a typical domestic customer (consuming 4,000 kWh) and small business customer (consuming 20,000 kWh). Numbers may not sum due to rounding.

4. Calculating the Victorian Default Offer price

4.3. Variation of a VDO price determination

The order provides that before or during a regulatory period, the commission may, on its own initiative, vary a VDO price determination in respect of the regulatory period.¹¹⁶ 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 making 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.

Our issues paper sought stakeholder feedback about what circumstances the commission should consider, and on what basis the commission should decide on, a proposed variation to a VDO price determination. We also sought views on what process the commission should adopt in making a variation to a VDO price determination. We noted that in most cases, any variation to a price determination would involve consultation in accordance with our stakeholder engagement framework.¹¹⁷

Submissions to our issues paper

amaysim submitted its preference for ongoing 6-monthly reviews of the VDO price determination which would allow for incremental changes (presumably to the components of the cost stack).¹¹⁸ Powershop suggested our determination should allow for volatile pricing events, stating:

Powershop believes that the VDO must be flexible enough to adapt to volatile pricing events (e.g. wholesale costs, supply events, network costs). Indeed, the VDO should embrace the same practices a retailer is required to adopt to accommodate cost changes, and be cost reflective based on material market movements.¹¹⁹

¹¹⁶ Clause 13(1) of the order.

¹¹⁷ Clause 13(5) of the order notes that we are not required to consult with stakeholders where the variation is not sufficiently material to warrant consultation in accordance with clause 14 of the order; or the need for the variation is sufficiently urgent to warrant consultation in accordance with clause 14 of the order not being undertaken.

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.

¹¹⁸ amaysim, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 5.

¹¹⁹ Powershop, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4.

Consumer Action Law Centre recommended that we should vary a price determination when not doing so would have a significant impact on Victorian households, and that the process for varying a VDO price determination should prioritise reducing any harm that may result for households.¹²⁰

Draft decision on the circumstances under which we would consider a variation

The VDO price determination will apply for a 12-month period from 1 January 2020. We note this is a relatively short period which we consider helps to limit the need to vary the VDO price determination within a regulatory period. We consider the circumstances in which a variation may be required will be limited to extraordinary events that have a significant impact on the costs of delivering electricity retail services. Other events can be considered during the next annual VDO price determination process, as suggested for changes to environmental cost obligations in section 3.3. This is consistent with the approach taken by other regulators in Australia.¹²¹ Limiting variations to significant and unforeseen industry-wide cost changes helps to balance the costs and benefits of regulation, provides for customer certainty about the VDO, and supports the objective of simplicity. It is our intention to monitor the retail electricity market with regard to specific events, as well as general trends that may impact the cost of retail supply.

We intend to provide a mechanism for making a variation to the VDO price determination if an event has occurred that:

- was uncertain or unforeseen at the time of making the price determination – such as an exogenous shock¹²², and
- is sufficiently material to impact on the benchmark established for the efficient costs of supply of an electricity retail service.

We note that the matters that trigger any variation may have an upward or downward impact on the components of the cost stack. Further, we note some submissions suggested we set a threshold to determine when a variation may take place. We consider it is in the interests of customers that the commission retains flexibility to assess the need for a variation on a case by case basis, having regard to our statutory requirements.

¹²⁰ Consumer Action Law Centre, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 9.

¹²¹ For example, the Independent Competition and Regulatory Commission (ICRC) in the ACT only consider pass-through events as part of their annual recalibration process. See ICRC, Final report: Standing offer prices for the supply of electricity to small customers from 1 July 2017, June 2017, p. 62.

¹²² An exogenous shock here refers to an event that occurs outside the control of a retailer or the industry.

Draft decision on the basis on which we would consider a variation

In considering a proposed variation, amongst other matters, we propose to consider the objectives of the VDO as set out in the order, and the ESC and EI Acts. As part of this assessment, we would consider the benefits and costs of the proposed variation¹²³, and the capacity of retailers to manage the impacts of the event until the start of the subsequent regulatory period and the long term interests of consumers.

Draft decision on the process to enable a proposed variation

The order provides that the commission may decide the nature and extent of stakeholder consultation it will undertake when making a decision to vary a VDO price determination.¹²⁴ The commission is required to have regard to its Charter of Consultation and Regulatory Practice and in the event that the commission initiates a variation to the VDO determination, we would in most cases consult with stakeholders in accordance with our stakeholder engagement framework.¹²⁵ However, where the variation is not sufficiently material to warrant consultation, or the need for the variation is sufficiently urgent we may not consult with stakeholders.¹²⁶

If the commission is satisfied that an event has occurred that meets the requirements outlined above, we may amend the price determination (adjusting prices) to give effect to the changes in costs faced by retailers.

Draft decision – approach to varying a VDO price determination

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

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

We may also make a variation to a VDO price determination to correct a clerical error, miscalculation, misdescription or other deficiency.

¹²³ Section 8A of the ESC Act requires we have regard to a number of matters, including the benefits and costs of regulation (including externalities and the gains from competition and efficiency) for consumers and users of products or services (including low income and vulnerable consumers), as well as the regulated entities.

¹²⁴ Clause 14(1) of the order.

¹²⁵ Clause 14(2) of the order.

¹²⁶ Clause 13(5) of the order.

4. Calculating the Victorian Default Offer price

5. VDO compliant maximum annual bill

The order requires us to determine the VDO compliant maximum annual bill (maximum bill) that will apply to standing offers that are not flat tariffs or tariffs that comprise a combination of a flat tariff and a non-flat tariff. Non-flat tariffs include time of use and flexible tariffs, or those that include demand charges.¹²⁷

The order requires the maximum bill must be based on¹²⁸:

- the standing offer tariffs that the commission determines are to apply in respect of flat tariffs, and
- customer electricity usage.

Our issues paper published in July 2019 proposed two possible approaches to determine the maximum bill.

The first approach proposed to use the prices we determined to apply in respect of flat tariffs, for a single level of consumption to calculate the maximum bill. 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 clause 15 of the order, which adopts representative consumption levels for domestic and small business customers of 4,000 kWh and 20,000 kWh per annum, respectively.

Under this approach, retailers would be required to structure non-flat standing offer tariffs in a way that complies with the maximum bill amount at the specific consumption point.

The second approach proposed to use the customer's actual consumption. We would use the prices we determine to apply in respect of flat tariffs, for the full range of consumption levels covered by the VDO. A maximum bill would be identified for electricity consumption ranging from zero to 40,000 kWh per year.

Each option has different implications for how a customer's bill would be compared to the maximum bill amount. Under the first approach either the commission or retailer would need to establish how the non-flat standing offer tariffs made available by a retailer would be compared with the representative annual bill amount for the purposes of compliance. Under the second approach, the bill amount is set based on the customer's consumption during the regulatory period

¹²⁷ Clause 10(2) of the order.

¹²⁸ Clause 12(5) of the order.

and the obligation would be on retailers to ensure a customer's bill at the end of the regulatory period does not exceed this.

5.1. Feedback from stakeholders

We received substantial feedback on the two maximum bill options set out in our issues paper. The Consumer Action Law Centre favoured the second option proposed in our issues paper. Their submission expressed support for non-flat standing offer prices to be capped at the level of the flat standing offer VDO tariff, stating this offers simple and appropriate protections that ensure all have access to a fair price for their electricity.¹²⁹

Several retailers preferred to align the maximum bill approach with the Default Market Offer methodology established by the AER, consistent with the first approach proposed in our issues paper (based on estimating a maximum bill at a single point of consumption). This was the preferred approach of the Australian Energy Council and several retailers, including Alinta Energy, Momentum Energy and ERM Power.¹³⁰

AGL, EnergyAustralia, Origin Energy, Simply Energy and Powershop proposed an alternative to the maximum bill, suggesting the commission instead set specific tariffs for customers on time of use standing offers and customers on other non-flat tariffs, or include time of use tariffs in the basis for the VDO compliant maximum bill amount.¹³¹

¹²⁹ Consumer Action Law Centre, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 9.

¹³⁰ Alinta Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4-5;

Momentum Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2;

ERM Power, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4;

Australian Energy Council, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3.

¹³¹ AGL, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 5;

EnergyAustralia, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4;

Origin Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3;

Simply Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3;

Powershop, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4.

5. VDO compliant maximum annual bill

Some retailers noted concern regarding our proposed approaches and the risks these represented for retailers, including cost exposure due to higher non-flat network tariffs.¹³² Some also noted that the approaches in our issues paper would not support cost-reflective tariffs.¹³³ In part, we consider these concerns reflect comments from retailers that they may not be able to shift customers from non-flat network tariffs to flat network tariffs, which could involve additional costs for the retailer.

AGL presented its own analysis that showed the network component of maximum bills based on time of use tariffs would exceed the amounts calculated for network bills calculated on flat tariffs for the representative customer in a number of circumstances (the implication being that the retailer would not be able to recover the costs of network tariffs in all circumstances under the approaches in our issues paper).¹³⁴ We note that this situation does not appear to occur in every circumstance. That is, AGL's analysis also showed a number of cases where time of use network costs were lower than for customers on flat network tariffs.

Red and Lumo Energy suggested we could protect retailers from this cost exposure by including a premium in the calculation of network costs for the maximum bill, or alternatively working with government to require network distributors to reassign VDO customers to flat network tariffs.¹³⁵

Some retailers also suggested the impact of the two approaches in our issues paper would be to reduce efficiency due to distorted price signals and its impact on customer demand. A number of retailers including Origin Energy, Red and Lumo Energy, Alinta Energy and Simply Energy were concerned that basing the maximum bill on an underlying flat network tariff would prevent peak and off peak price signals.¹³⁶ They suggested without these price signals customers would not be

¹³² AGL, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4-5, or

EnergyAustralia, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4, or

Origin Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 1.

¹³³ Origin Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3, or

Powershop, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4, or

Simply Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4

¹³⁴ AGL, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4-5.

¹³⁵ Red and Lumo Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

¹³⁶ Alinta Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4, or

5. VDO compliant maximum annual bill

incentivised to shift their demand to off peak periods, therefore reducing market efficiency provided by peak and off peak price signals. In its response, Origin Energy stated:

We believe a regulatory framework that prevents a business from recovering incurred regulated costs (i.e. network charges) should be avoided because not only is it economically unsound, it creates unnecessary regulatory risk and perverse price signals.¹³⁷

Red and Lumo Energy also discussed the impact of price signals in their response to our issues paper:

...consumption during peak times can fluctuate from one year to the next, particularly without price signals that discourage consumption during peak periods.¹³⁸

We note these concerns and agree the intended effect of cost-reflective tariffs is to incentivise more efficient consumption via price signals. Our view is the first approach we proposed in our issues paper provides flexibility for retailers to maintain price signals in their non-flat standing offer tariffs. However, the ability of these signals to change consumption relies on the customer's response to the prices they are charged. Considering the objective of the VDO is to safeguard customers unable or unwilling to engage in the electricity retail market, it is less likely that price signals provide incentives for more efficient consumption for this group of electricity consumers.

Some stakeholders raised the difficulties involved in monitoring compliance with both of the maximum bill approaches we outlined in our issues paper (particularly approach two).

EnergyAustralia wrote:

Tracking any over-recovery of bill amounts for individual customers and monitoring compliance at this level would involve considerable effort.¹³⁹

Simply Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4, or

Origin Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3.

Red and Lumo Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

¹³⁷ Origin Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 1.

¹³⁸ Red and Lumo Energy, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

¹³⁹ EnergyAustralia, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 5.

Consumer Action Law Centre noted the potential for harm from over-charging if adjustments were made after the customer's bill has been issued.¹⁴⁰ This was also reflected by retailers EnergyAustralia and ERM Power, who noted the negative customer experience and potential reputation damage for industry likely to arise from frequent bill adjustments.¹⁴¹

The inherent complexity and variation of customer consumption patterns was noted as a risk by retailers such as Red and Lumo Energy and ERM Power. ERM Power noted:

Finally, the complexity of time of use tariffs for small business customers due to the variability of this customer type, should not be underestimated or dismissed.¹⁴²

5.2. Our draft decision for calculating the VDO compliant maximum annual bill

Our approach to the maximum bill is guided by the requirements of the order, including the objective of the VDO to provide a simple, trusted and reasonably priced option that safeguards customers unable or unwilling to engage in the retail electricity market. We have also considered how our approach best meets the objectives of the ESC and EI Acts.

We consider that calculating the maximum bill at a single representative level of annual consumption best meets the objectives and matters required under the statutory instruments. Consistent with the approach taken in the order for calculating an annual bill for the purposes of discounting, our draft decision is to set the representative customer's consumption at 4,000 kWh for domestic customers and 20,000 kWh for small business customers.¹⁴³ Taking this approach results in a total of ten maximum bills – one for domestic customers and one for small business customers in each of the five Victorian distribution zones. The maximum bill for each customer type and distribution zone would likely be presented in conjunction with the flat standing offer tariffs we determine.¹⁴⁴

¹⁴⁰ Consumer Action Law Centre, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 9.

¹⁴¹ ERM Power, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 3,

EnergyAustralia, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4.

¹⁴² ERM Power, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 2.

¹⁴³ Clause 15(5) of the order.

¹⁴⁴ For example, if our price determination presented the flat standing offer tariffs consistent with Schedules 1 and 2 of the order then the maximum bill could be included as additional column to those tables, with the maximum bill listed for the relevant distribution zone.

To verify that standing offer tariffs comply with the maximum bill at either of the two specified consumption points, we propose that retailers use a representative profile of customer usage.

If offering a discount, retailers are currently required to estimate the annual cost of their non-flat market offers and compare it with an estimated annual bill based on the flat standing offer tariffs that apply from 1 July 2019.¹⁴⁵ For a five or seven-day time of use structure, or flexible tariff structure, retailers are required to apply usage profiles specified in the order.¹⁴⁶ These profiles are reproduced in table 12 below.

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

Table 12 – Representative customer usage profiles

We propose to apply the profiles in table 12 for the calculation of the maximum bill. This will support consistency in the way market offers are currently compared to VDO tariffs, with the way non-flat standing offer tariffs will be compared under the framework from 1 January 2020.

For a tariff type not covered in table 12, we propose a retailer submits to the commission their estimation of any usage profile that is not covered in table 12, at the time of publication of their standing offers.¹⁴⁷ The estimated profile must be based on the usage of the standing offer customers on that tariff type. The profile would reflect an estimate of consumption for the 12-month period beginning 1 January 2020. The obligation would be on the retailer to justify the usage profile

¹⁴⁵ Clause 15 of the order.

¹⁴⁶ Table 1, Schedule 3, and clause 15 of the order.

¹⁴⁷ Retailers are required to publish their standing offers to apply from 1 January 2020 in the period 25 November to 18 December 2019. This is set out in clause 2(b) of the Ministerial Order dated 22 May 2019, published in the Victorian Government Gazette No. S 208 on Thursday 30 May 2019.

5. VDO compliant maximum annual bill

adopted.¹⁴⁸ We believe this approach is appropriate, balancing the costs and benefits of the regulatory approach adopted, given the relatively small numbers of customers on standing offers that do not use flexible, or five or seven-day time of use tariffs. Preliminary analysis of standing offers gazetted in June 2019 indicates that a number of retailers may already comply with this approach, which is likely to mean that any additional costs of regulation will be minimised.

The box below provides a worked example of how this proposal would operate for a five-day time of use (covered in table 12) and general usage with demand (not covered by table 12) standing offer.

Worked examples of the VDO compliant maximum annual bill

Five-day time of use (domestic)

For illustrative purposes we have assumed that the maximum bill for this distribution zone for a domestic customer is \$1,300. In practice the maximum bill would be calculated by taking the flat tariff standing offer tariffs for the relevant distribution zone and estimating the annual bill for 4,000kWh domestic customer. The annual consumption for this customer type is 4,000 kWh per annum that is split by 52 per cent in peak period and 48 per cent in the off peak (as specified in table 12). In this scenario the peak and off-peak usage tariffs, published by the retailer, are multiplied by the consumption to estimate the total cost in dollars. Similarly, the daily supply charge is multiplied by the number of days in the regulatory period, to give the total costs for that component.

As shown in the table below, this results in a bill of \$1,300, which does not exceed the maximum bill. Therefore, this proposed five-day time of use standing offer tariff would comply with the price determination.

¹⁴⁸ The commission may request the retailer submit the past 12 months of smart meter data for the customers on that particular standing offer tariff to review the appropriateness of assumptions. Based on a review of this data, the commission may decide whether any customers would overpay on that standing offer tariff type.

General usage (4,000 kWh /annum)			
	Consumption (kWh)	Rate (c/kWh)	Total
Peak	2,080	28.2403	\$587.40
Off-peak	1,920	20.4693	\$393.01
Service Charges			
	Days	Daily rate (\$/day)	
Daily Charges	366	\$0.8732	\$319.59
Subtotal			\$1,300.00
Illustrative VDO compliant maximum annual bill			\$1,300.00

General usage with demand (small business)

For illustrative purposes, we have assumed maximum bill for this distribution zone for a small business customer is \$5,000. In practice the maximum bill would be calculated by taking the flat tariff standing offer tariffs for the relevant distribution zone and estimating the annual bill for 20,000kWh domestic customer.

The annual consumption for this customer type is 20,000 kWh per annum that is split across summer and non-summer usage. Despite this, the general usage rates under this proposal do not differ between periods. In this scenario the proposed demand charges do differ between summer and non-summer periods. The maximum demand calculated for the summer and non-summer periods is equal to 2.5 times the average daily consumption in the relevant period. Similarly, the daily supply charge differs between summer and non-summer, with each rate multiplied by the number of days in the relevant period, to give the total costs for that component. This usage profile is not based on analysis of actual data, but is used for illustrative purposes.

As shown in the table below, this results in a bill of \$5,000, which does not exceed the maximum annual bill. Therefore, this proposed general use with demand charge standing offer tariff would comply with the price determination, subject to commission consideration of the data used to justify the consumption profiles.

	Summer			Non-summer			
General usage (20,000 kWh /annum)							
	Consumption (kWh)		Rate (c/kWh)	Consumption (kWh)		Rate (c/kWh)	Total
Peak	9,400		19.8583	10,600		19.8583	\$3,971.65
Demand charge							
	Maximum demand (kW)	Days	Rate (c/kW/day)	Maximum demand (kW)	Days	Rate (c/kW/day)	Total
	5.71	122	47.2950	4.57	244	19.8583	\$550.59
Daily Charges							
	Days		Daily rate (\$/day)	Days		Daily rate (\$/day)	Total
	122		\$1.2599	244		\$1.3281	\$477.76
Subtotal							\$5,000.00
Illustrative VDO compliant maximum annual bill							\$5,000.00

Basis for our decision

In making our draft decision on the approach to determining the maximum bill we have had regard to our statutory requirements. The prices paid by domestic and small business customers (using less than 40 MWh per annum) on non-flat standing offers will be based on an assessment of the efficient costs of supply for electricity retail services. In this way, the framework will provide a safeguard for customers unwilling or unable to engage in the electricity retail market, which we consider promotes the long-term interests of Victorian consumers.

We note that our draft decision approach complements and takes into account other reforms made by the commission to improve protections for customers.¹⁴⁹ The requirement from 1 July 2019 for retailers to present the best generally available offer on a customer's bill provides an important protection that is targeted at each particular customer's usage profile. We believe that this targeted reform complements the broad safeguard that is provided by the maximum bill in our draft decision.

While regulating the level of prices, our draft decision also provides flexibility for retailers to continue to offer retail tariffs that reflect the structure of underlying network tariffs, and to promote cost reflective pricing. This supports objectives in the order and ESC Act relating to efficiency. We note ongoing reforms to network tariffs to make them more cost reflective, and consider it is important the VDO framework accommodates the provision of cost-reflective prices. We consider that our draft decision reduces the chance of unintended consequences, which were raised in

¹⁴⁹ Essential Services Commission, Building trust through new customer entitlements in the retail energy market: Final Decision, October 2018.

response to approach two in our issues paper, where a customer who is currently benefitting from more cost-reflective tariffs no longer has that option available to them. Moreover, we do not believe that regular changes in the structure of tariffs for customers over consecutive years (e.g. if the default network tariff becomes more cost-reflective in 2021) is likely to be in the long-term interests of consumers.

We note that where actual network costs (under non-flat network tariffs) differ from the flat tariff standing offer we determine, it is not always the case that retailers will face higher costs. Analysis from AGL as part of its submission to our issues paper highlights that there are circumstances where network costs can be either above or below what has been allowed.¹⁵⁰ We believe that our proposed approach has regard to both efficient costs of the sale of electricity of a retailer and financial viability of the industry by providing some flexibility for retailers to develop their standing offer tariffs to meet the maximum annual bill cap.

Our draft decision also provides for simplicity and consistency with regulatory arrangements already in place, lowering administrative costs. Our proposed approach is consistent with the assumptions adopted by the order to measure discounts for market offers. Our proposed approach is also similar to that taken by the AER to the Default Market Offer, which estimates compliance of retailers' standing offers at a specified level of consumption (differing by domestic and small business customers). Further, our draft decision means that retailer compliance will be assessed by the commission, which has regard to the VDO's objective to provide a safeguard for customers who are unable or unwilling to engage in the market.

We have considered alternative proposals from stakeholders who commented on our approaches to the maximum bill. We consider the order provides clear direction that in the first regulatory period we must determine the maximum annual electricity bill for customers on non-flat standing offer tariffs.¹⁵¹ The order also states the maximum bill should be based on the flat standing offer tariffs we determine and customer electricity usage.¹⁵² We have decided that the alternative proposals, to set the rates for many different non-flat standing offer tariffs, does not best meet the objectives of VDO. In particular, the presence of both a maximum annual bill and regulated tariffs is unlikely to provide a simple option for customers who are unwilling or unable to engage in the market.

¹⁵⁰ AGL, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 4-5.

¹⁵¹ Clause 10(2)(a)(ii) of the order.

¹⁵² Clause 12(5) of the order.

5. VDO compliant maximum annual bill

We also consider that including a premium to account for the risk of uncertain costs under non-flat network tariffs, as recommended by Red and Lumo Energy, may not satisfy the requirement of the order for the maximum bill must be based on the flat standing offer tariffs we determine.

Comparison of approaches

While the discussion above sets out the basis for our draft decision, we note that our issues paper signalled preliminary support for a different approach. Our issues paper indicated we preferred approach two, summarised above. Our draft decision adopts and further develops approach one from our July 2019 issues paper.

We consider both approaches provide a safeguard for customers but do so in different ways. Both also meet the requirement of the order for the maximum bill to be based on the flat standing offer tariffs we will determine and on customer usage. While our issues paper indicated that we thought that approach two provided more transparency, we now consider that this approach may not provide a simple option and could also require action to be taken by a customer where they believe they have overpaid. In contrast we believe that our draft decision takes a simple approach, which provides a broad safeguard for customers, noting that there are limits on how uncertain the impact would be on customers with different levels of consumption. We also believe that it is less likely to create unintended consequences, particularly for those customers who are responding to and benefitting from more cost-reflective tariffs.

Weighing a range of factors, including considering the submissions we received to our July 2019 issues paper, we believe there is greater justification for adopting an enhancement of approach one. In particular:

1. There is greater ability for retailers to reflect their efficient costs under approach one.
2. There is also likely to be lower costs associated with administration under approach one.
3. There is benefit in aligning our approach with both the Default Market Offer framework and the approach retailers take to calculate discounts in Victoria.
4. Approach one is less likely to result in cross-subsidisation between standing offer customers.
5. Customers with consumption levels and profiles that differ from the representative levels we have chosen receive other targeted protections, including the best offer obligation.

Based on these matters, we believe there are clear benefits to adopting approach one. Table 13 provides a summary comparing approaches one and two against a range of objectives we must consider in making a determination on the maximum bill.

Several retailers raised concerns that approach two in our issues paper created a large administrative burden associated with reviewing customer accounts and applying any credits due to overpayment, as well as the additional costs incurred if a customer has to be manually

transferred to a different network tariff. While we note Consumer Action Law Centre supported approach two from our issues paper (for a maximum bill to be set for every consumption level), its submission also noted a preference for customers to receive protections up front rather than retrospectively.¹⁵³ We believe that our proposed approach should limit the need for retrospective credits for customers because retailers will need to ensure that published standing offer tariffs comply with the maximum annual bill ahead of the regulatory period commencing.

	Issues paper – approach 1	Issues paper – approach 2
Safeguard for disengaged customers	✓✓✓ Broad safeguard created by applying to all non-flat standing offer tariffs	✓✓✓ Specific safeguard as each individual customer's bill is compared to max bill
Based on efficient costs	✓✓ Flexibility for retailers to design tariffs to recover costs	✓ Less flexibility to recover costs as each individual customer's bill is capped despite underlying network tariff costs
Long term interest of consumers	✓✓	✓
<i>Administrative costs of regulation</i>	✓✓ Up front design and publication of tariffs and representative consumption determines compliance	✓ More administrative cost associated with retrospectively reviewing all bills and possibly applying credits. Possible additional costs of manually transferring customers onto flat network tariffs.
<i>Regulatory consistency</i>	✓✓ More aligned with compliance approach for Default Market Offer and approach to calculating discounts in Victoria	✓ No real alignment with other similar regulations
<i>Efficiency in the industry</i>	✓✓ Flexibility for retailers to design non-flat tariffs that recover costs from that group of customers	✓ Greater chance of cross-subsidisation by customers with bills below the maximum annual cap, including the removal of cost reflective price signals

Table 13 – Comparison of approaches to determining the maximum annual bill

¹⁵³ Consumer Action Law Centre, submission to the Essential Services Commission, Victorian Default Offer to apply from 1 January 2020: Issues Paper, August 2019, p. 9-10.

5. VDO compliant maximum annual bill

Draft Decision – approach to the VDO compliant maximum annual bill

The commission proposes to set the VDO compliant maximum annual bill based on the flat standing offer tariffs we determine, and a representative usage profile for the customer group.

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

Retailers must publish all standing offers for the regulatory period beginning 1 January 2020 (including the flat standing offers we determine) in the Government Gazette in the period 25 November to 18 December 2019.

- If offering a flexible, five or seven-day time of use (or the 5-day time of day/9pm off peak) standing offer tariff, a retailer must demonstrate those tariffs do not exceed the relevant VDO compliant maximum annual bill using the approach detailed in Schedule 3 of the order (replicated in table 12).
- For any other non-flat standing offer tariff, a retailer must demonstrate that these tariffs do not exceed the relevant maximum annual bill by using a representative usage profile reflecting an estimate of consumption for that group of customers in the 12-month period beginning 1 January 2020. This usage profile must be submitted to the commission when the retailer publishes these standing offer tariffs in the Government Gazette.

Glossary

Term	Definition
ACCC	Australian Competition and Consumer Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AMI	Advanced Metering Infrastructure (i.e. smart meters)
ASX	Australian Stock Exchange
CARC	Customer acquisition and retention costs
DLF	Distribution Loss Factors
ESC	Essential Services Commission
FiT	Feed-in Tariff
ICRC	Independent Competition and Regulatory Commission (Australian Capital Territory)
IPART	Independent Pricing and Regulatory Tribunal (New South Wales)
kWh	Kilowatt Hours
LGC	Large-scale Generation Certificate
LRET	Large-scale Renewable Energy Target
MLF	Marginal Loss Factor
Monte Carlo simulation	The process of using repeated random sampling to obtain a numerical result
MRIM	Manually Read Interval Meter
MWh	Megawatt Hour
NEM	National Electricity Market

NUOS	Network Use Of System
PPA	Power Purchasing Agreement
QCA	Queensland Competition Authority
REPI	Retail Electricity Pricing Inquiry
RERT	Reliability and Emergency Reserve Trader
RPP	Renewable Power Percentage
RRO	Retailer Reliability Obligation
SRES	Small-scale Renewable Energy Scheme
STC	Small-scale Technology Certificate
STP	Small-scale Technology Percentage
VDO	Victorian Default Offer
VEEC	Victorian Energy Efficiency Certificates
VEU	Victorian Energy Upgrades

Appendix A – Order in Council

Victorian Government Gazette

No. S 208 Thursday 30 May 2019

By Authority of Victorian Government Printer

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

1. Purpose

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

2. Commencement

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

3. Objective of the Victorian default offer

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

4. Definitions

1. In this Order:

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

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

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

Example: A storage water heater is such an appliance.

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

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

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

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

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

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

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

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

- (a) the time of day;
- (b) the amount of electricity distributed or supplied during the day;
- (c) temperature, whether actual or forecast; or
- (d) other characteristics that vary during the day.

Notes:

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

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

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

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

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

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

kWh means kilowatt hour;

Minister means the Minister administering the Act;

MWh means megawatt hour;

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

Order means this Order;

prescribed customer: see clause 5;

quarter means a period of 3 consecutive months;

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2. Despite subclause (1), in:

- (a) clause 6;
- (b) clause 7;
- (c) clause 10(2)(a)(i),
- (d) schedule 1; and
- (e) schedule 2,

the following definitions instead apply:

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

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

Notes:

- 1. The following terms are defined in section 3 of the Act: Commission; domestic or small business customer; distribution company; electricity bill; regulated tariff standing offer; retailer; standing offer.
- 2. As at the date of the commencement of this Order, the Order in Council made under section 35 of the Act and published in the Government Gazette No. S 315 on 25 November 2008 applies for the purposes of the definition of ‘domestic or small business customer’ in the Act.
- 3. ‘price determination’ is defined in section 13(6) of the Act.

5. Declaration of Prescribed customers

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

- (a) a domestic or small business customer;
- (b) a former franchise customer who is a party to a deemed contract under section 37 of the Act; and
- (c) a relevant customer who is a party to a deemed contract under section 39 of the Act.

6. Victorian default offer tariffs

- 1. A retailer’s standing offer tariffs for sale of electricity to prescribed customers must comply with this clause.
- 2. During the period from 1 July 2019 to 31 December 2019, the standing offer tariffs a retailer may charge to a domestic customer, in respect of the distribution zone specified in column 1 of the table in Schedule 1, are fixed at the amounts specified in columns 2, 4 and 5 of the table for the tariff components specified in those columns.
- 3. During the period from 1 July 2019 to 31 December 2019, the standing offer tariffs a retailer may charge to a small business customer, in respect of the distribution zone specified in column 1 of the table in Schedule 2, are fixed at the amounts specified in columns 2 and 4 of the table for the tariff components specified in those columns.
 - 4. Subclauses (2) and (3) do not apply to standing offer tariffs other than:
 - (a) a flat tariff; or
 - (b) a flat tariff with a controlled load tariff.
- 5. During any regulatory period commencing on or after 1 January 2020, a retailer’s standing offer tariffs for sale of electricity to prescribed customers must comply with any VDO price determination made by the Commission that is in force.

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

7. Retailer must make Victorian default offer

1. A retailer's regulated tariff standing offer for sale of electricity to prescribed customers must include (specified as the '*Victorian default offer in respect of flat tariffs*'):
 - (a) one flat tariff that is available to each domestic customer;
 - (b) one flat tariff with a controlled load tariff that is available to each domestic customer with a controlled load; and
 - (c) one flat tariff that is available to each small business customer, which tariffs must be:
 - (d) for the period from 1 July 2019 to 31 December 2019, those fixed in accordance with clause 6(2) and clause 6(3);
 - (e) for any regulatory period commencing on or after 1 January 2020, standing offer tariffs complying with the VDO price determination in respect of that regulatory period.
2. In addition, for any regulatory period commencing on or after 1 January 2020 and in the case of standing offer tariffs that:
 - (a) are not flat tariffs; or
 - (b) are any combination of a flat tariff, and a tariff that is not a flat tariff,a retailer's regulated tariff standing offer must include standing offer tariffs and terms and conditions (both specified as the '*Victorian default offer in respect of the VDO compliant maximum annual bill*') that ensure the retailer's compliance with the VDO price determination in respect of that regulatory period.

8. Information about the VDO on electricity bills

1. This clause applies until such time as the amendments to the Energy Retail Code required by clause 16(2)(b) come into force.
2. A retailer's electricity bill issued to a prescribed customer on or after 1 October 2019 must include information about how the customer may access the Victorian default offer from the retailer.
3. The information required by subclause (2) must be in plain and clear English and prominent on the electricity bill.

9. Conferral of functions and powers on the Commission

1. For the purposes of Part 3 of the ESC Act and section 12(1)(b) of the Act, the supply or sale of electricity under the Act is specified as prescribed goods and services in respect of which the Commission has the power to regulate prices.
2. The Commission may not make a price determination regulating tariffs for the supply or sale of electricity under the Act except as contemplated under this Order.

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

10. Commission to make VDO price determination

1. At least 37 days before the commencement of a regulatory period, the Commission must make a price determination in respect of the regulatory period that determines, for each distribution zone in Victoria:
 - (a) the tariffs, or the maximum tariffs, a retailer may charge prescribed customers under a standing offer during the regulatory period; or
 - (b) the manner in which the tariffs, or the maximum tariffs, a retailer may charge prescribed

customers under a standing offer during the regulatory period are to be determined or calculated.

2. Without limiting subclause (1), the price determination that the Commission makes in respect of the first regulatory period:
 - (a) must determine:
 - i. the standing offer tariffs that are to apply in respect of flat tariffs, including, in the case of domestic customers, both flat tariffs and flat tariffs with a controlled load tariff; and
 - ii. in the case of a prescribed customer who is on:
 - A. a tariff that is not a flat tariff; or
 - B. any combination of a flat tariff, and a tariff that is not a flat tariff, the maximum annual electricity bill amount that the prescribed customer is to pay under a standing offer in the regulatory period (*VDO compliant maximum annual bill*); and
 - (b) may provide, in the case of the customers specified in subclause (2)(a)(ii), for how any overpayment by those customers in that regulatory period, or any year (or part year) thereof, is to be dealt with; and
 - (c) may also include any other decisions or determinations that are required by this Order.
3. Despite subclause (2), the Commission may after its first price determination, determine another manner pursuant to which the standing offer tariffs referred to in that subclause are to be determined or calculated.

11. Regulatory periods for VDO price determinations

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

12. Approach and methodology for making a VDO price determination

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

Note: section 33(2) of the ESC Act requires the Commission to adopt an approach and methodology that best meets the objectives of the ESC Act and of the **Electricity Industry Act 2000**.
2. In addition, the Commission must adopt an approach and methodology which the Commission considers will best meet the objective of the Victorian default offer.
3. The tariffs determined by the Commission pursuant to the VDO price determination are to be based on the efficient costs of the sale of electricity by a retailer.
4. For the purposes of subclause (3), the Commission must have regard to:
 - (a) wholesale electricity costs;
 - (b) network costs;
 - (c) environmental costs;
 - (d) retail operating costs, including modest costs of customer acquisition and retention;
 - (e) retail operating margin; and
 - (f) subject to subclause (10), any other costs, matters or things the Commission, in the exercise of its discretion, considers appropriate or relevant.

Note: Section 33(3)(e) of the ESC Act similarly requires the Commission to have regard to any other factors that it considers relevant.

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

Notes:

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

13. **Variation of VDO price determinations**

1. Before or during a regulatory period, the Commission may, on its own initiative, vary a VDO price determination in respect of the regulatory period.
2. The Commission must specify, in a VDO price determination, the circumstances under which the Commission will consider, and the basis on which the Commission will decide on, a proposed variation and (subject to subclauses (4) and (5)) the processes to be followed to enable the Commission to make such a variation.
3. Without limiting subclause (1), the Commission may vary a VDO price determination:
 - (a) if an event has occurred or will occur that was uncertain or unforeseen by the Commission at the time of making the VDO price determination; or
 - (b) to correct a clerical error, miscalculation, misdescription or other deficiency.
4. Before making a variation, the Commission must consult in accordance with clause 14.
5. Subclause (4) does not apply if:
 - (a) the variation is not sufficiently material to warrant consultation in accordance with clause 14; or
 - (a) the need for the variation is sufficiently urgent to warrant consultation in accordance with clause 14 not being undertaken.
6. If, as a result of a variation of a VDO price determination, a retailer is or will be required to vary the retailer's standing offer tariffs, the Commission must ensure the retailer is given adequate notice before the variation to the VDO price determination takes effect.

14. **Consultation**

1. The Commission may decide the nature and extent of stakeholder consultation it will undertake when

- making a VDO price determination or a decision to vary a VDO price determination.
2. For the purposes of subclause (1), the Commission must have regard to its Charter of Consultation and Regulatory Practice (as amended from time to time) developed and published under section 14 of the ESC Act.
15. **Victorian default offer tariffs to be the reference tariffs for discounts**
1. This clause applies until such time as the amendments to the Energy Retail Code required by clause 16(2)(a) come into force.
Provided that, if those amendments do not provide for any matter provided for in this clause, then this clause continues to apply in respect of that matter.
 2. A retailer that offers a discount to a domestic customer or a small business customer must:
 - (a) if the discount is in respect of the period from 1 July 2019 to 31 December 2019, disclose how the discount is calculated as against the tariffs in Schedule 1 or Schedule 2 (as the case may be), and what (in percentage or dollar terms) the reduction in tariff is in terms of those tariffs; and
 - (b) if the discount is in respect of a regulatory period, disclose how the discount is calculated as against the flat tariffs determined by the Commission pursuant to the VDO price determination that applies in respect of that period, and what (in percentage or dollar terms) the reduction in tariffs is in terms of those tariffs.
 3. For the purposes of subclause (2), the reduction in tariffs is to be expressed as the difference between the estimated annual cost of the Victorian default offer for the customer type and distribution zone, and the estimated annual cost of the offer to which the discount relates after the discount is applied, using the annual reference consumption.
 4. For the purposes of subclause (3):
 - (a) the estimated annual cost of the Victorian default offer is:
 - i. during the period from 1 July 2019 to 31 December 2019, determined by applying Schedule 3;
 - ii. during a regulatory period, determined by applying Schedule 3 or any other approach or methodology determined by the Commission; and
 - (b) the retailer must determine the estimated annual cost of the retailer's offer to which the discount relates:
 - i. if the tariff is a flat tariff or a flexible tariff (in either case, with or without a controlled load), by applying Schedule 3;
 - ii. otherwise, based on a reasonable estimate having regard to any relevant information available to the retailer; and
 5. The annual reference consumption is:
 - (a) during the period from 1 July 2019 to 31 December 2019:
 - i. for domestic customers without a controlled load – 4,000 kWh general usage per annum;
 - ii. for domestic customers with a controlled load – 4,000 kWh general usage plus 2,000 kWh controlled load usage per annum;
 - iii. for small business customers (with or without a controlled load) – 20,000 kWh general usage per annum.
 - (b) during a regulatory period:
 - i. the consumption amount determined by the Commission (if any); or
 - ii. if no amount is determined by the Commission pursuant to subclause (5)(b)(i), the amount specified in subclause (5)(a).
 6. For the purposes of subclause (5), the amount of electricity consumed is assumed to be the same on

each day of the year.

7. Any percentage or dollar amount disclosed pursuant to this clause must be expressed as a whole percentage or dollar, rounded to the nearest percentage or dollar.
8. Otherwise, Division 2 of Part 2A (*Customers entitled to clear advice*) of the Energy Retail Code applies to the disclosures required by this clause.

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

1. The Commission must, as soon as practicable after the commencement of this Order, amend the Energy Retail Code and any other instrument of the Commission to give effect to the Victorian default offer and this Order.
2. Without limiting subclause (1), the Commission must amend the Energy Retail Code (and any other instrument of the Commission) so that the Code:
 - (a) provides for tariffs determined by the Commission pursuant to the VDO price determination being the reference tariffs for discounts and for the methodology of that comparison; and
 - (b) requires a retailer's electricity bill to include information about how the customer may access the Victorian default offer from the retailer.
3. For the purposes of subclause (2)(a), the Commission must have regard to the following principles:
 - (a) There must be a consistent methodology for comparison of tariffs that applies to:
 - i. all offers of discounts by retailers; and
 - ii. the advertising in respect of those discounts.
 - (b) The methodology must apply in respect of flat tariffs and tariffs that are not flat tariffs;
 - (c) The methodology must (without limitation) readily allow, in respect of a regulatory period, a comparison between:
 - i. the discounted tariffs offered by a retailer; and
 - ii. the tariffs determined by the Commission pursuant to the VDO price determination in respect of that period; and
4. Any actual comparison in accordance with the methodology must be readily understandable by a prescribed customer. Subclause (3) does not limit:
 - (a) the matters the Commission may have regard to; or
 - (b) the matters the Commission may provide for by way of the amendments required by subclause (2).

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

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

SCHEDULE 1

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

Charges are inclusive of GST.

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

SCHEDULE 2

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

Charges are inclusive of GST.

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

SCHEDULE 3

1. Estimated annual cost for flat tariff offers

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

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

where:

EAC is the estimated annual cost of the offer;

SC is the supply charge;

UC is the general usage charge; and

ARC is the annual reference consumption for general usage.

2. Estimated annual cost for flexible tariff offers

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

$$EAC = SC \times 365 + ARC \times UC_p \times UA_p + ARC \times UC_s \times UA_s + ARC \times UC_{op} \times UA_{op}$$

where:

EAC is the estimated annual cost of the offer;

SC is the supply charge; and

ARC is the annual reference consumption for general usage;

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

UC_p is the retailer's peak usage charge;

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

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

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

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

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

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

where:

EAC is the estimated annual cost of the offer;

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

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

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

Table 1 – Usage allocation for flexible tariffs

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

Dated 28 May 2019 Responsible Minister
HON. LILY D'AMBROSIO MP
Minister for Energy, Environment and Climate Change

PIETA TAVROU
Clerk of the Executive Council

Electricity Industry Act 2000

MINISTERIAL ORDER UNDER SECTION 35(3B)

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

1. Commencement

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

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

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

- (a) the period commencing on the date this Order commences and ending on 17 June 2019; and
- (b) the period commencing on 25 November 2019 and ending on 18 December 2019.

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

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

- (a) if the variation is under clause 2(a) – on 1 July 2019; and
- (b) if the variation is under clause 2(b) – on 1 January 2020.

4. Expiry of this Order

This Order expires on 31 March 2020.

Dated 22 May 2019

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

Appendix B – List of submissions to our issues paper

Name of organisation	Date received
Active Utilities	12/08/2019
The Australian Energy Council	12/08/2019
amaysim	12/08/2019
Consumer Action Law Centre	12/08/2019
EnergyAustralia	12/08/2019
Energy Intelligence	12/08/2019
ERM Power	12/08/2019
Momentum Energy	12/08/2019
Network Energy Services	12/08/2019
Origin Energy	12/08/2019
Powershop	12/08/2019
Simply Energy	12/08/2019
AGL	13/08/2019
Alinta Energy	13/08/2019
Red and Lumo Energy	13/08/2019

Brotherhood of St Laurence	14/08/2019
Victorian Public Tenants Association	15/08/2019