Victorian Default Offer 2023-24

Consultation Paper

8 December 2022

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Essential Services Commission 2022, Victorian Default Offer 2023-24: Consultation Paper, 8 December

Contents

Review of the Victorian Default Offer for 2023-24

- The Essential Services Commission is starting to review the Victorian Default Offer prices to apply for 2023–24.
- In general, we propose to keep our approach to setting Victorian Default Offer prices largely unchanged.
- We propose to pass through market intervention costs in the Victorian Default Offer prices.
- We note the impact of inflation on the Australian economy and will consider its impact on retailers' costs.
- Wholesale electricity prices have increased significantly since we made our last decision on the Victorian Default Offer in May 2022. The final impact of these cost increases on Victorian Default Offer prices will not be known with complete certainty until we release our final decision in May 2023.
- We seek stakeholder views on our consultation paper by **30 January 2023**.

The Victorian Default Offer regulates standing offer prices

The Victorian Default Offer was introduced by the Victorian Government to regulate standing offer prices for electricity in Victoria.[1] The first Victorian Default Offer was set by the Victorian Government in 2019 based on advice prepared by us. Our first determination of Victorian Default Offer prices came into effect 1 January 2020. We have been responsible for setting Victorian Default Offer prices since then.

Standing offers provide an important safeguard for customers

As the Victorian Default Offer is intended to be a reasonable price, it provides an important safeguard for customers who may be on a standing offer contract and disengaged from the market.

[1] Order in Council made under section 13 of the *Electricity Industry Act 2000* and published in the *Victorian Government Gazette* No. S 208 on Thursday 30 May 2019. An amendment to schedule 1 was ordered in the *Victorian Government Gazette*, No. S 216 Tuesday 4 June 2019 (updating controlled load charges). A standing offer is defined in section 3 of the *Electricity Industry Act 2000* and means a 'licensee standing offer' or a 'regulated tariff standing offer' as defined in section 3 of this Act.

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

- never signed up for an electricity contract
- entered into an electricity contract, cancelled the contract within the cooling-off period, but continues to use electricity without entering into a new contract
- moved into a new address and uses electricity without entering into a contract
- specifically asked for a standing offer or
- moved onto a standing offer after their market offer contract came to an end.[2]

The Victorian Default Offer specifies the prices that may be charged for standing offers. Around 330,000 households and 49,000 small businesses are on standing offers.[3] This represents around 12 per cent of households and 17 per cent of small businesses. This is an increase from seven per cent of households and 16 per cent of small businesses last year. This is another 130,000 thousand customers that are benefitting from the protections included in the Victorian Default Offer.

Since September 2020, the Victorian Default Offer has also applied as a maximum price for most embedded network customers (covering around 140,000 customers).[4] Electricity providers in embedded networks may set prices below the Victorian Default Offer.

The Victorian Default Offer also acts as a comparison price

Most customers are on market contracts, not standing offers. And there are a number of market offers available with prices below the Victorian Default Offer.

The Victorian Default Offer plays a key role as a benchmark price for these market offers. Retailers must compare their market offers and discounts to the default offer prices when advertising. This enables customers to easily compare market offer prices and choose a plan that best suits their needs.

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[2] We note that recent increases in the number of standing offer customers are due to two major retailers moving fixed-term retail contract customers onto standing offers at the end of their contract periods. This has been behind most of the recent increase in standing offer customers over the last year.

[3] Data collected through voluntary reporting from retailers.

[4] Embedded networks supply electricity for many domestic and small business customers in apartment buildings, caravan parks or office blocks. A domestic customer is a person who purchase electricity principally for personal, household or domestic use. A small business customer is a business customer who consumes no more than 40 megawatt hours of electricity per year. Source: Essential Services Commission, *Maximum prices for embedded networks and other exempt sellers: Final decision,* July 2020, p. ii.

We must review prices before the end of each regulatory period

We released our previous determination on 24 May 2022 for the Victorian Default Offer to apply from 1 July 2022 to 30 June 2023. We refer to these arrangements for standing offers as the 2022–23 Victorian Default Offer.

Under the pricing order, we must make a new determination for the Victorian Default Offer to apply from 1 July 2023 to 30 June 2024 before 25 May 2023.[5] We refer to the new arrangements for standing offers to apply from 1 July 2023 as the 2023–24 Victorian Default Offer.

In making our determinations for the Victorian Default Offer, we are guided by the requirements of an Order in Council made under section 13 of the Electricity Industry Act 2000 (pricing order). We must adopt an approach and methodology that best meets the objective of the Victorian Default Offer. This objective is to provide a simple, trusted and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the electricity retail market.

The government has reviewed the pricing order

As required under the pricing order, the Minister for Energy, Environment and Climate Change appointed a panel to review the operation and effectiveness of the pricing order in 2022.[6] The final report of the review of the pricing order, was provided to the Minister for Energy, Environment and Climate Action and Solar Homes on Friday 21 October 2022.

The review found that there is no need for any major overhaul of the pricing order and that the Victorian Default Offer is meeting its primary objectives.[7] If the government responds to the review with any changes to the pricing order, we will consider those changes in our Victorian Default Offer determination.

Wholesale electricity costs have increased since our last decision

Wholesale electricity prices increased significantly in May 2022 and have stayed high since. Our current approach to wholesale electricity costs (using contracts from the futures market) will account for the impact of the higher wholesale prices.

To ensure that our decision reflects the best and most recent market information available we will update our forecasts when we make our final decision in May 2023. Before that time we cannot be

[5] Clause 10(1) of the pricing order.

[6] Clause 17 of the pricing order.

[7] *Review of the Victorian Default Offer Order in Council: Final Report*, October 2022, p. 5 last available at: https://engage.vic.gov.au/download/document/29721 [last accessed 10 November 2022].

certain of what the exact impact of the increase in wholesale prices on Victorian Default Offer prices will be.

We are seeking stakeholders' views on the Victorian Default Offer

We consider using largely the same approach as we did in the 2022–23 Victorian Default Offer, will best meet our legislative objectives and requirements.[8] In preparing the 2023–24 Victorian Default Offer we will update our cost benchmarks to reflect changes in market-based data where relevant. We consider this approach meets all relevant provisions and matters we must have regard to under the *Essential Services Commission Act 2001*, *Electricity Industry Act 2000* and the pricing order. **We will require strong new evidence to depart from the methodology we have used in past reviews.** Table 1 below summarises the areas we are seeking feedback on.

Table 1: summary of areas for stakeholder consideration

Consultation item	Past approach	Proposed approach
Market intervention costs	We include other market fees and charges from the Australian Energy Market Operator in the 'other costs' benchmark when determining Victorian Default Offer prices.	We propose to include market intervention costs in the Victorian Default Offer cost benchmarks. Our approach to passing these costs through will depend on their size and timing, and taking into account impacts on customers, retailers, and the costs of regulation.
Retail operating costs	Estimated based on a benchmark set by the Independent Competition and Regulatory Commission in 2017 and adjusted for the change in the consumer price index since 2017.	We seek feedback on alternative options for setting the retail cost benchmark for the Victorian Default Offer.
Consumer data right costs	No adjustment was made to account for new consumer data right obligations. These costs were provided for through the existing retail operating cost and retail operating margin benchmarks.	We seek information from stakeholders on the ongoing retail operating costs associated with the expansion of the consumer data right to new retailers.
Customer acquisition costs	Estimated based on cost levels from the Australian Competition and Consumer Commission's retail and electricity pricing inquiry's final report[9] updated for inflation.	We seek feedback on alternative options for setting the customer acquisition cost benchmark for the Victorian Default Offer.

[8] Essential Services Commission, *Victorian Default Offer 2022–23: Final decision*, 24 May 2022.

[9] Australian Competition and Consumer Commission, Retail electricity pricing inquiry – Final report, July 2018.

Consultation papers	We have published a consultation paper at the start of almost every Victorian Default Offer review	We propose to only publish a consultation paper for Victorian Default offer reviews if we are considering major changes to our methodology for setting Victorian Default Offer prices.

Stakeholders may also wish to comment on any other aspect of the Victorian Default Offer.

Table 2 provides indicative timelines for the 2023–24 Victorian Default Offer review.

Table 2: Timeframes for the 2023–24 Victorian Default Offer

Key milestones	Indicative date
Submissions on consultation paper close	30 January 2023
Draft decision released	early March 2023
Public forum on the draft decision	mid-March 2023
Submissions on the draft decision close	late March 2023
Final decision and determination	By 25 May 2023

How to provide feedback

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

Both general comments and formal submissions to our consultation paper should be made by 5pm 30 January 2023. We may place lower weight on, or may not be able to consider, submissions received after these dates.

Visit Engage Victoria's website to make your submission: www.engage.vic.gov.au.

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

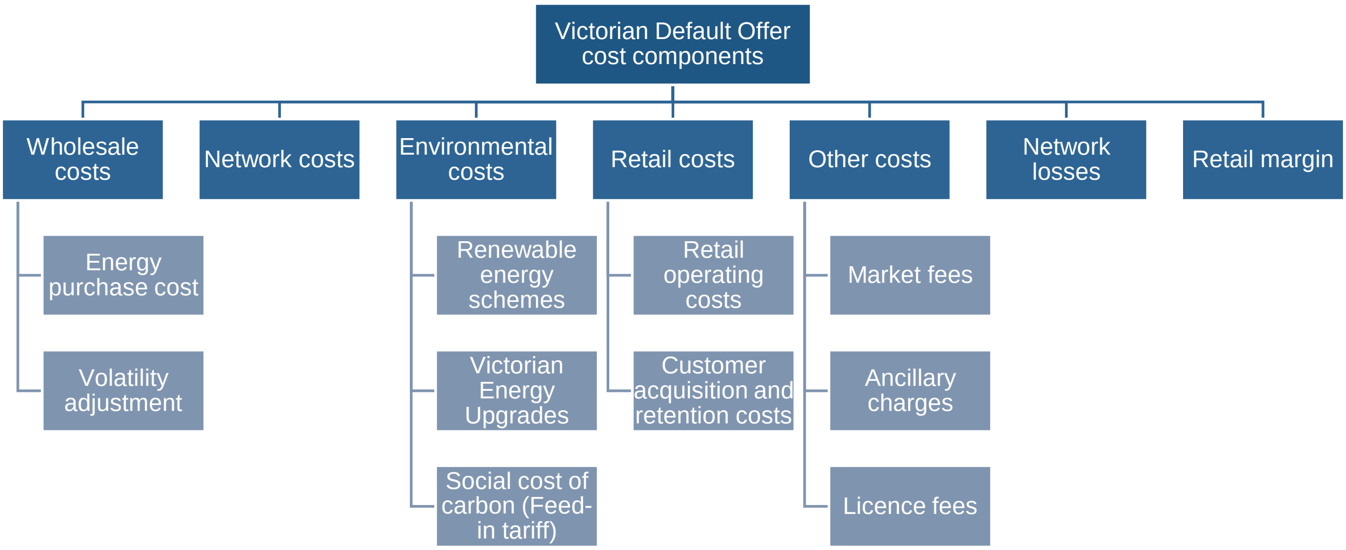
Sensitive or confidential information

All submissions come under the commission's submissions policy. Submissions will be made available on our website, except for any information that is commercially sensitive or confidential. Submissions should clearly identify which information is sensitive or confidential.

Cost components in the Victorian Default Offer

We must base the Victorian Default Offer on the efficient costs of the sale of electricity by a retailer.[10] In doing this, we must have regard to set cost components in setting tariffs.[11] The costs included in our Victorian Default Offer cost model are shown below.

Figure 1: Cost items included in the Victorian Default Offer cost stack



We use a number of different approaches to estimate the benchmarks for the costs used to calculate the Victorian Default Offer prices, including:

- wholesale electricity costs – based on the price of electricity costs in the futures market
- network costs – taken directly from tariffs approved by the Australian Energy Regulator
- environmental costs – taken from public information on the costs of environmental initiatives
- retail costs – based on benchmarks from previous regulatory decisions
- other costs – taken directly from published reports from industry bodies
- network losses – taken from the Australian Energy Market Operator and electricity distributors
- retail operating margin – based on a benchmark from comparable regulatory decisions.

As part of this review, we will update the estimates included in the cost stack to reflect the most up-to-date information available for our draft decision and again prior to the final decision.

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[10] Pricing Order clause 12(3).

[11] Pricing Order clause 12(4).

As in past years, we will also collect cost data from retailers using our compulsory information gathering powers[12]. This year we will be collecting information from all retailers in Victoria with more than 10,000 small customers.

Wholesale costs

Retailers incur wholesale electricity purchase costs when they buy electricity from the wholesale market to meet customer demand. The pricing order requires us to have regard to the efficient costs of wholesale electricity purchases.[13]

Purchasing electricity through the national electricity market

Electricity retailers must secure a supply of wholesale electricity from the national electricity market: commonly called the spot market. The spot market is where the Australian Energy Market Operator (market operator) matches the supply of electricity from power stations with real time consumption by households and businesses.

All electricity in the spot market is bought and sold at the spot price.[14] The spot price changes every five minutes, and this exposes retailers to the risk that prices may be high when they need to purchase electricity.

Managing wholesale electricity risk

Hedging is a way of managing the risk of high spot prices. If a retailer hedges its wholesale electricity risk, at least some of the prices it pays are set in advance or capped. Commonly traded hedging products are futures contracts on ASX Energy. These contracts guarantee retailers can purchase electricity at a fixed price in the future or place a limit on the maximum amount they must pay. Other hedging methods include contracting directly with generators or through financial intermediaries. Additionally, some retailers are vertically integrated as they own generation assets, which can be seen as another hedging method. Prices associated with ASX Energy contracts are made public, while those from other methods are generally not.

We use a futures market approach to benchmark wholesale costs

We have used a futures market approach to estimate wholesale electricity costs in previous reviews. This approach is summarised below.

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[12] Essential Services Commission Act 2001, Section 36

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

[14] Source: Australian Energy Market Operator, spot and contract markets, accessed 1 October 2022, https://www.aemc.gov.au/energy-system/electricity/electricity-market/spot-and-contract-markets

1. We calculate the average futures contract prices from the past 12 months weighted by the share of trades at each price.[15] This reflects retailers' practice of building their hedging contract position over time.[16]
2. The pattern of half-hourly demand and spot prices are forecast using historical half-hourly demand and spot prices from recent years. This makes the forecast more reliable as it reduces its reliance on demand and supply patterns from any single year.
3. The forecast half hourly spot prices from step 2 are then increased or decreased so that on average they are equal to the prices implied by the hedging contract prices from step 1. This makes the forecast consistent with the market's expectations of the future.
4. Finally, given expected prices and demand, the STRIKE model[17] calculates an optimal hedging contract position for a prudent retailer.

This provides us with residential and small business wholesale cost forecasts for each distribution zone.

Our approach to wholesale costs accounts for the impact of recent market events

Wholesale prices increased significantly in the second quarter of 2022 and have stayed high since. Between 1 May and 31 July 2022, the average wholesale spot price in Victoria was approximately 250 per cent higher than the average spot price at the same time in 2021. This was due to a number of factors, including:

- higher international coal and gas prices
- domestic fuel supply concerns
- coal-fired plant outages – leading to higher cost gas plants being used more
- an early start to winter that created higher than expected demand.[18]

We also note that following these events some retailers may not have the same access to hedging services as some financial institutions have ceased offering some hedging services.

We consider that the futures market approach remains a good method for setting a wholesale cost benchmark. The futures market approach accounts for the impact of higher wholesale prices.

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[15] Prices and volumes are considered for three most common contracts – base swaps, peak swaps and base $300 caps.

[16] A hedging contract position is the mix of different types of hedging contracts a retailer enters into to reduce its exposure of risk.

[17] A proprietary model owned and operated by Frontier Economics. See Frontier Economics, *Wholesale electricity costs for 2022-23: A final report for the Essential Services Commission*, May 2022, p. 33.

[18] *NEM market suspension and operational challenges in June 2022*, Australian Energy Market Operator, August 2022, pp. 11-14.

The prices at which futures contracts are traded reflect generators' and retailers' expectations of wholesale costs. This means the contract prices include market participants' expectations about market events on future wholesale electricity spot prices.

For example, when a generator expects running costs to increase at a certain point in time in the future, it may raise the prices of the contracts it offers.[19] If retailers consider the cost to be within a reasonable range of their own forecasts, they will buy contracts at the increased price. If retailers consider the prices to be unreasonable, they will not buy more contracts until the price lowers.

The futures market approach has several other strengths. It is more transparent than its alternatives as it uses publicly available data. It also replicates the approach an efficient retailer would take to minimising wholesale costs for a given risk appetite and having a reasonable level of hedge cover. The futures market approach is also consistent with the approach used by other Australian regulators.[20]

In July 2022 we used our information gathering powers to collect information from retailers about how they hedge and manage wholesale risk. We looked at the hedging positions and how far in advance retailers generally start hedging. This showed the assumptions used in our approach to forecasting a wholesale electricity benchmark are broadly aligned with how most retailers hedge. We also note that while retailers use a variety of methods to hedge, including using internal physical hedges (vertical integration), power purchasing agreements and over-the-counter forward contracts, most retailers also use ASX Energy futures contracts.

For these reasons we consider using ASX futures contracts provides a reasonable proxy for the hedging positions retailers take. Further, alternative approaches (accounting for over-the-counter contracts and vertical integration with generators) are likely to require further assumptions and be less transparent. Some other approaches are also likely to lead to similar price outcomes. In Victoria over-the-counter forward contract prices have been similar to those for ASX futures contracts and have broadly similar price movements over time.

We also note that although ASX Energy futures contracts are traded often, the volumes being traded on ASX Energy for Victorian futures have decreased in the last year. However, the market remains relatively liquid, especially in contrast to some other state markets. We will continue to monitor developments in the Victorian market and other state markets ahead of making our decision on the 2023-24 Victorian Default Offer.

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[19] There are multiple factors that can drive the increase in costs including fuel prices and availability, expected plant outages, and higher than usual demand for electricity.

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

We propose to retain the futures market-based methodology

We propose to continue to use trade-weighted futures contract prices for the most recent 12 months available. The detailed methodology is outlined in our consultant's report for the final decision for the 2022–23 Victorian Default Offer.[21]

Network costs

Network costs represent the cost of building, operating and expanding the electricity distribution and transmission network. We are required to have regard to network costs in estimating efficient costs. Network costs account for a bit more than a third of the costs reflected in the Victorian Default Offer. We base our network cost benchmark on the tariffs for Victoria's five distribution networks. These tariffs are approved by the Australian Energy Regulator on an annual basis.

We propose to retain this cost pass-through approach for the Victorian Default Offer 2023–24 review. For our draft decision on these network costs, we intend to use the network tariffs approved by the Australian Energy Regulator for 2022–23. Network tariffs for 2023–24 are scheduled to be finalised by the Australian Energy Regulator in early May 2023. We intend to update the Victorian Default Offer to reflect the finalised tariffs in our final decision.

Environmental costs

In calculating the Victorian Default Offer, we must have regard to environmental and other regulatory costs in establishing the efficient costs of the sale of electricity by a retailer.[22]

Victorian electricity retailers face four main environmental costs which relate to the:

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

We use a variety of different methods to forecast these costs. Our final decision on the 2022–23 Victorian Default Offer provides an explanation of each of these approaches.[23]

For the 2023–24 Victorian Default Offer price review, we consider it appropriate to retain the same approaches to estimating environmental costs. We will update our forecasts using the most

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[21] Frontier Economics, *Wholesale electricity costs for 2022–23: A final report for the Essential Services Commission*, May 2022.

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

[23] Essential Services Commission 2022, *Victorian Default Offer 2022–23: Final decision*, 24 May, p. 19.

recently available data where possible. We note that maintaining these approaches will ensure consistency with our approach to estimating retailers' costs.

Other fees and charges

Other regulatory costs include a range of other costs that retailers incur. These costs are generally small relative to the total cost stack (less than one per cent), but we must consider them in our benchmark of the efficient costs. These other costs include:

- Australian Energy Market Operator fees
- ancillary fees
- Reliability and Emergency Reserve Trader costs
- Essential Services Commission licence fees.

We propose to maintain a pass through approach for each of these costs as used in the 2022–23 Victorian Default Offer.

Impact of recent events in the National Electricity Market

In addition to the other regulatory costs mentioned above, recent events in the National Electricity Market have led to retailers facing extra costs. These events relate to the Australian Energy Market Operator's intervention in the wholesale market.

Wholesale electricity prices increased significantly in early 2022. The market operator took temporary steps to stabilise the market in June 2022. These included introducing an Administered Price Cap on wholesale electricity prices and suspending the wholesale market and directing generators to supply as required. Generators incurred costs because of these actions.

Electricity generators who were financially disadvantaged during these events can make compensation claims. If the claims are successful, the costs are then passed on to electricity retailers. The National Energy Rules, sets out the process for these claims.[24]

The total cost that electricity retailers will face because of the market operator's intervention is made up of:

- directions compensation
- suspension pricing compensation
- administered pricing compensation
- Reliability and Emergency Reserve Trader payments.

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[24] For more information see: AEMC National Electricity Rules - Rule 3.14 Administered Price Cap and Market Suspension.

Types of compensation and process for payment

Directions compensation and **suspension pricing compensation** are both administered by the Australian Energy Market Operator. These forms of compensation allow generators to recover costs above the wholesale electricity price, at the time they were directed to supply (directions compensation) or during the period of market suspension (suspension pricing compensation).

The market operator estimated provisional amounts for compensation. In Victoria a total of $2.3 million was settled.[25] There is a second tranche of compensation for when generators claim the provisional amounts are not enough to cover their costs. The second tranche is scheduled to be settled in January 2023. The market operator has only published an indicative total figure for the second tranche of $114.4m for the whole of Australia.[26]

Administered pricing compensation allows generators to recover their costs when they are higher than the revenue they receive under the Administered Price Cap. This form of compensation can be claimed for both direct costs and opportunity costs. Currently, the Australian Energy Market Commission has not published a timeline for when these claims will be settled.

The **Reliability and Emergency Reserve Trader scheme** is a mechanism that the Australian Energy Market Operator can use to maintain power system reliability. During the June 2022 event, this scheme was not activated in Victoria, so there will be no costs to pass through from this event.

Impact of market intervention costs on retailers

A prudent energy retailer will hedge (often through futures) their wholesale market exposure to protect them from volatility in spot prices. When the Australian Energy Market Operator intervened in the wholesale market, it effectively exposed retailers to higher wholesale costs but capped the revenue retailers could receive though hedging. There is no mechanism for retailers to claim compensation from the market operator for the lost hedging revenue that would have offset the higher wholesale costs. As a result, we would expect an efficient retailer to pass market intervention costs through to their customers.

Our initial position is to include the compensation costs in the 2023–24 Victorian Default Offer. Passing through these costs will allow retailers to recover their efficient costs. It is consistent with the pricing order to base Victorian Default Offer prices on electricity retailers' efficient costs.[27]

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[25] For more information on the amounts claimed for directions compensation and suspension pricing compensation mentioned in this section see: AEMO June 2022 NEM Events: Compensation Update (15 August 2022).

[26] Australian Energy Market Operator, see: NEM suspension costs lower than expected (18 August 2022).

[27] Clause 12(3) of the Order.

Options for passing through market intervention costs

There are several options for how these costs can be passed through, broadly following our approach to passing through other market operator costs. However, unlike other market operator costs, the total amount that electricity retailers will have to pay is currently unknown and it is not clear when the total amount will be known.

Some of these costs will be known when we make our decision on the 2023–24 Victorian Default Offer and could therefore be passed through at that point. Additional costs will become known over subsequent months. We could either account for these costs in the 2024–25 Victorian Default Offer or pass them through as a variation to the 2023–24 Victorian Default Offer as soon as they are known.

The circumstances under which we may consider and decide on a proposed variation to the Victorian Default Offer, and matters we will have regard to, are set out in clause 6 of the Victorian Default Offer Price Determination 2022–23.[28] Among other things these include:

- the timing, duration and magnitude of the event or circumstance,
- the costs and benefits to retailers and prescribed customers of a proposed price determination variation, and
- the capacity of retailers to manage the impact until the commencement of the next regulatory period.

We are seeking stakeholders' views on how costs resulting from the June 2022 market intervention should be reflected in the Victorian Default Offer prices.

Retail costs

The pricing order requires us to have regard to retail operating costs when making a Victorian Default Offer price determination.[29] Retail operating costs reflect a range of costs incurred by electricity retailers, including:

- billing and revenue collection systems
- information technology systems
- call centre costs

[28] Essential Services Commission 2022, Victorian Default Offer Price Determination 2022-23: 1 July 2022 – 30 June 2023, pp. 7-8.

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

- corporate overheads
- energy trading costs
- provisions for bad and doubtful debts
- regulatory compliance costs.

We are seeking stakeholders' views on alternative approaches to retail operating costs

Our current benchmark for retail operating costs per customer is based on a benchmark set by the Independent Competition and Regulatory Commission for retail electricity prices in the Australian Capital Territory.[30] We increase this benchmark in line with changes in the consumer price index each year and add some costs to reflect regulatory costs not included in the original benchmark.

We have cross checked the benchmark with data provided by Victorian retailers on their costs in past reviews. The benchmark for retail operating costs has been within the range of Victorian retailers' actual costs.[31] This shows that our approach has provided retailers with a reasonable opportunity to recover efficient costs.

In this review we are seeking stakeholder feedback on:

- the potential impact of high increase in the consumer price index on our benchmark
- changes in consumer data right obligations for retailers.

Impact of high consumer inflation on retail operating costs

Annual inflation is currently higher than it has been since 1990. Two of the largest contributors to annual inflation are higher food and automotive fuel prices.[32] Neither of these items make up a significant share of retailers' costs. If we continue to escalate retail operating costs by changes in the consumer price index our benchmark could become less representative of retailers' costs.

During previous Victorian Default Offer reviews, the consumer price index has been used as a proxy for increases in retail operating costs. In a low inflation environment this transparent assumption is reasonable. However, given the large increase in the consumer price index, and smaller increases in wages (which make up the largest share of retail operating costs), it may no

[30] Independent Competition and Regulatory Commission, *Standing offer prices for the supply of electricity to small customers from 1 July 2017, Final decision*, June 2017, p. 48

[31] Including retailers' bad debt costs which account for roughly two per cent of their total costs.

[32] Australian Bureau of Statistics (Sep-quarter-2022), *Consumer Price Index, Australia*, ABS Website, accessed 11 November 2022.

longer be as reasonable. In this context, we seek submissions on alternative methods that could be used to set a retail operating cost benchmark.

Some of the options stakeholders may wish to comment on include setting the benchmark using:

- cost data collected from Victorian electricity retailers – this could be used to set the overall retail operating cost benchmark, or used as a way to estimate changes in costs to apply to the current benchmark
- a different index such as the wage price index
- a basket of different indexes
- a benchmark from another Australian regulator
- some other method.

In assessing alternatives, we will use a principles based approach. An ideal method to setting the retail operating cost benchmark would be:

- efficient: it would create incentives for retailers to provide the services customers want at lowest long run sustainable cost
- accurate: it would be an accurate representation of retailers' efficient costs
- transparent: it would be replicable
- simple: it would be easy to understand
- stable: it would not lead to frequent large increases or decreases in costs.

We encourage stakeholders to consider these measures of a desirable method for setting a benchmark in submissions on the retail operating cost benchmark.

Consumer data right costs

The Consumer Data Right is a reform designed to allow consumers greater access to, and control over, their data so they can compare and switch between retailers.[33] During the 2022–23 review, we found evidence that suggested the ongoing costs of complying with the Consumer Data Right for the first tranche of retailers were very low.[34] With the Consumer Data Right applying to more electricity retailers in 2023–24 we seek feedback from stakeholders on the cost impact of the reforms on this next tranche of retailers. In particular, we seek information on the ongoing operating costs associated with the reforms.

We are seeking stakeholders' views on:

[33] Competition and Consumer (Consumer Data Right) Amendment Rules (No. 2), 2021 (Cth)

[34] Essential Services Commission 2022, *Victorian Default Offer 2022-23: Draft decision*, 15 March 2022, p. 23

- alternative retail operating cost benchmarks
- the cost impact of the consumer data right on retailers.

Customer acquisition and retention costs

The pricing order requires us to include a modest allowance for customer acquisition and retention costs (acquisition costs) in making our Victorian Default Offer determinations. These costs include:

- the cost of acquisition channels (such as third-party comparison websites or telemarketing)
- the cost of retention teams
- marketing costs targeted at driving customer acquisition or retention.

In all past determinations for the Victorian Default Offer, we have used a benchmark to estimate modest acquisition costs.[35] Our final decision on the 2022–23 Victorian Default Offer provides an explanation of the approach to calculating the benchmark.[36]

Under normal conditions, acquisition costs have the potential to increase, resulting in an 'arms race' in which retailers spend increasing amounts on customer acquisitions to gain market share. Our benchmark is based on limiting the impact of increased acquisition costs since 2013–14.[37] While our 'modest' benchmark achieves this, it still sits within the amounts reported to us by retailers.[38]

We also note that a recent review of the Victorian Default Offer pricing order found that our 'interpretation of the term 'modest' appears to be operating satisfactorily to balance stakeholders' interests'.[39]

We seek feedback on the impact of consumer prices on our acquisition cost benchmark

As for retail operating costs, in past determinations we have used changes in the consumer price index as a proxy for changes in acquisition costs. It is not clear whether the consumer price index

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[35] Essential Services Commission, *Victorian Default Offer to apply from 1 July 2019: Advice to Victorian Government*, 3 May 2019, p. 66; Essential Services Commission, *Victorian Default Offer to apply from 1 January 2020: Final decision*, 18 November 2019, p. 47; Essential Services Commission, *Victorian Default Offer 2021: Final Decision*, 25 November 2020, p. 36; Essential Services Commission, *1 January 2022 Victorian Default Offer: Final decision*, 25 November 2021, p. 39; Essential Services Commission, *Victorian Default Offer 2022–23: Final decision*, 24 May 2022, p. 27

[36] Essential Services Commission, *Victorian Default Offer 2022–23: Final decision*, 24 May 2022, p. 27

[37] Essential Services Commission, *Victorian Default Offer to apply from 1 July 2019: Advice to Victorian Government*, 3 May 2019, p. 76

[38] Essential Services Commission, *Victorian Default Offer 2022–23: Final decision*, 24 May 2022, p. 27-28

[39] Department of Environment, Land, Water, and Planning 2022, *Review of the Victorian Default Offer Order in Council, Final decision*, October 2022, p. 26-27

is appropriate in the long term given that the goods in the consumer price index may not reflect those in retailers' acquisition costs.

We are interested in hearing stakeholders' views on whether there are more appropriate ways to set acquisition costs. Given this, we seek stakeholders' views on options to setting a benchmark for acquisition costs. Some options stakeholders may wish to comment on includes:

- A benchmark using actual acquisition costs from Victorian electricity retailers
- A different benchmark from other regulators
- Any other recommendation from stakeholders

As for retail operating costs, any submissions should explain how the proposals are: efficient, accurate, transparent, simple and stable.

We are seeking submissions on potential alternatives for determining our approach to consumer acquisition and retention costs.

Retail operating margin

The pricing order also requires us to have regard to the retail operating margin when making a Victorian Default Offer price determination.[40] The retail operating margin represents the operating profit margin required to compensate investors for the capital provided to operate a retail service. The retail operating margin is expressed as a percentage of the cost stack.

Our initial view is to maintain the retail margin at 5.7 per cent

We propose to maintain the current retail operating margin for this review. During previous Victorian Default Offer reviews, we have undertaken reviews of our methodology for estimating the retail margin.[41] This included looking at approaches used by other regulators and analysing cost data provided by Victorian retailers. These reviews suggested that our retail margin is within the range of margins in the Victorian retail electricity market and adopted by regulators in other jurisdictions.

As part of this review, we will re-examine the approaches used by other regulators and analyse the most up-to-date cost data available to us. We will also monitor changes in financing costs given that interest rates have increased over the past year. However, as was the case when interest

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

[41] Essential Services Commission 2021, *1 January 2022 Victorian Default Offer: Final decision*, 25 November 2021, p.43.

rates were unusually low in 2020 and 2021, we are unlikely to change the margin solely in response to short term changes.

Calculating tariffs and the maximum annual bill

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

1. **Flat Victorian Default Offer tariffs -** for standing offers with flat tariffs
2. **Two-period time of use Victorian Default Offer tariffs –** for standing offers with two-period time of use tariffs.

We also set a **compliant maximum annual bill** to regulate standing offers with non-flat tariffs, other than two-period time of use tariffs. The compliant maximum annual bill is based on the two-period time of use tariffs.

Tariff structure

Our approach to tariff structure is guided by the pricing order.[42] The pricing order states that objective of the Victorian Default Offer "is to provide a simple, trusted and reasonably priced offer available to safeguard customers who are unwilling or unable to engage in the electricity retail market"[43].

Considering this objective, we propose that it is best satisfied by setting Victorian Default Offer flat tariffs, time of use tariffs and a compliant maximum annual bill.

Flat Victorian Default Offer tariffs

Our determination will include standing offer rates for flat tariffs. The objectives of the Victorian Default Offer are well served by using a simple flat tariff structure including: a daily supply charge, a flat, anytime usage charge, and a controlled load charge for domestic customers. Flat tariffs provide a simple option that is easy to understand.

Cost allocation

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

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[42] Order in Council made under section 13 of the *Electricity Industry Act 2000* and published in the *Victorian Government Gazette* No. S 208 on Thursday 30 May 2019.

[43] Victorian Government 2017, *Victoria Government Gazette* No. S 36, Tuesday 21 February 2017, Clause 3

Two-period time of use Victorian Default Offer tariffs

Our Victorian Default Offer determination will set standing offer rates for two-period time of use tariffs to apply to domestic and small business customers. The two-period time of use tariff are calculated based on the new default time of use network tariff structure and prices approved by the Australian Energy Regulator. We also propose to adopt the usage profiles we used in our last Victorian Default Offer Determination.[44] This serves the objective of the Victorian Default Offer by ensuring that standing offer tariffs are reasonable and reflect underlying costs.

Cost allocation

To set the rates for the two-period time of use tariffs, we use a simple and logical method to allocate costs. Fixed costs are contained in the daily supply charge. Any costs that vary with usage go into the variable, per kilowatt hour charge component of the tariffs. The variable cost components for peak and off-peak usage charges are the same except for network costs. We use the Australian Energy Regulator's approved two-period time of use network tariffs and apply them accordingly.

Maximum bill

In addition to setting the tariffs described above, we also regulate standing offers with non-standard tariff structures (for example demand tariffs). We do this through setting a maximum bill amount based on the flat Victorian Default Offer tariffs at a representative customer usage. The compliant maximum annual bill amount for other non-flat standing offers is calculated using the consumption amounts and usage profiles as for the two-period time of use tariffs.

As in past determinations retailers choosing to offer non-standard standing offer tariffs will be required to show those tariffs do not exceed the relevant compliant maximum annual bill amount.

We take this approach as it best meets our obligations in the pricing order. It extends the safeguard of the Victorian Default Offer to all standing offer customers without removing the option of non-standard tariffs from customers currently receiving them.

[44] Essential Services Commission, *Victorian Default Offer Price Determination 2022-23: 1 July 2022 – 30 June 2023*, May 2022.

Other considerations

Updated Order in Council

As required under the pricing order, the Minister for Energy, Environment and Climate Change appointed a panel to review the operation and effectiveness of the pricing order.[45] An expert chair led the review supported by a secretariat from the Department of Environment, Land, Water and Planning.[46]

The final report of the review of the pricing order, was provided to the Minister for Energy, Environment and Climate Action and Solar Homes on Friday 21 October 2022.

The review found that, aside from some minor amendments, there is no need for any major overhaul of the pricing order. The review found the Victorian Default Offer is meeting its primary objectives.[47]

If the government response to the review leads to changes to the pricing order, we will consider those changes in making our Victorian Default Offer determination.

Consultation process for the Victorian Default Offer reviews

In future reviews we propose to consult on Victorian Default Offer decisions by releasing a draft decision. We will not publish consultation papers prior to a draft decision unless we plan to make significant changes to our methodology for forecasting retailers' costs.

We consider this is appropriate given that we review Victorian Default Offer prices yearly. We have also received feedback from some stakeholders that, as the pricing methodology is well established, starting our reviews with a draft decision will help lower the regulatory burden on stakeholders.

Other questions for stakeholders on the Victorian Default Offer

Should we continue to publish Victorian Default Offer Consultation Papers each year?

[45] Clause 17 of the pricing order.

[46] *Review of the Victorian Default Offer Order in Council: Consultation Paper – March 2022*, Department of Environment, Land, Water and Planning 2022, p. 4-5.

[47] *Review of the Victorian Default Offer Order in Council: Final Report*, October 2022, p. 5 last available at: https://engage.vic.gov.au/download/document/29721 [last accessed 10 November 2022].