BIS OXFORD ECONOMICS

NOTE ON CHANGES TO AER TREATMENT OF INFLATION

ADDENDUM - PREPARED BY BIS OXFORD ECONOMICS
FOR THE VICTORIAN ELECTRICITY DISTRIBUTION BUSINESSES

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BIS Oxford Economics

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The modelling and results presented here are based on information provided by third parties, upon which BIS Oxford Economics has relied in producing its report and forecasts in good faith. Any subsequent revision or update of those data will affect the assessments and projections shown.

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ADDENDUM: PROPOSED CHANGE TO AER TREATMENT OF INFLATION

In October 2020, the Australian Energy Regulator (AER) released a 'Draft position' paper, titled "Regulatory Treatment of Inflation". Unfortunately, the timing of the paper was such that it was released **after** the report by BIS Oxford Economics (BISOE) – 'Labour Cost Escalation Forecasts to FY2026' (October 2020) - was compiled for the Victorian Electricity Distribution Businesses ("the DBs").

Accordingly, this Addendum is a note to inform the AER and other relevant stakeholders that the AER's proposed 'new' methodology (as proposed in their 'Draft position' paper) has **not been incorporated** into the BISOE report. This means that BISOE employed the current methodology for the CPI inflation forecasts: "estimating expected inflation uses a 10 year average of the Reserve Bank of Australia's (RBA) headline rate forecasts for 1 and 2 year ahead, and the mid-point of the RBA's target band—2.5 per cent—for years 3 to 10." (Draft position – Regulatory Treatment of Inflation. October 2020, page 7). This can be seen below in the accompanying table (replicated from page 5 of the original report), as indicated by footnote (d).

Table 1.1 Summary Table – Labour Cost Escalation Forecasts for Victoria and Australia – including Impact of Proposed Superannuation Guarantee Increases (financial years)

(per cent change, year ended June)

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	5 yr Avg (f)
	Actuals					Forecasts	Next Regulatory Period					
NOMINAL PRICE CHANGES												
1. Internal Electricity Network-Related Labour												
EGWWS WPI - Victoria (a)	**3.3**	**2.9**	**2.8**	**3.0**	**3.3**	**2.2**	**2.1**	**2.4**	**2.8**	**3.0**	**3.0**	**2.7**
EGWWS WPI - Australia (b)	2.4	2.2	2.0	2.8	2.7	1.9	1.9	2.2	2.7	2.9	2.9	2.5
2. General Wages												
Victoria WPI (c)	**2.3**	**1.9**	**2.3**	**2.6**	**2.4**	**0.9**	**1.2**	**1.7**	**2.2**	**2.5**	**2.5**	**2.0**
Australia All Industries - WPI (b)	2.1	2.0	2.1	2.3	2.1	1.1	1.4	1.8	2.3	2.5	2.5	2.1
Consumer Price Index (headline) (d)	1.4	1.7	1.9	1.6	1.3	1.5	1.3	1.8	2.2	2.2	2.2	1.9
REAL PRICE CHANGES (e)												
1. Internal Electricity Network-Related Labour												
EGWWS WPI - Victoria	**1.9**	**1.2**	**0.9**	**1.4**	**1.9**	**0.8**	**0.8**	**0.6**	**0.6**	**0.9**	**0.9**	**0.8**
EGWWS WPI - Australia	1.0	0.5	0.0	1.1	1.3	0.4	0.6	0.4	0.5	0.8	0.7	0.6
2. General Wages												
Victoria WPI	**1.0**	**0.2**	**0.4**	**1.0**	**1.1**	**-0.6**	**-0.1**	**-0.1**	**0.1**	**0.4**	**0.3**	**0.1**
Australia All Industries - WPI (b)	0.7	0.2	0.1	0.7	0.8	-0.3	0.0	0.0	0.1	0.3	0.3	0.2

Sources: BIS Oxford Economics, ABS

(a) Electricity, Gas, Water and Waste Services (EGWWS) for Wage Price Index (WPI) for Victoria
(b) Australian sector wage forecasts provided for comparison.
(c) Victoria WPI is total or 'All Industries' wage movements.
(d) Inflation forecasts are RBA forecasts for the next 2 years from latest 'Statement of Monetary Policy'. Beyond that, inflation forecasts are based on mid-point of RBA inflation target, but overall forecasts are calculated as a geometric mean of the 'official' RBA inflation forecasts over the next 10 years. This methodology has been adopted by the AER in its recent revenue decisions
(e) Average Annual Growth Rate for 2021/22 to 2025/26 inclusive ie for the next regulatory period.
(f) Real price changes are calculated by deducting the inflation rate from nominal price changes.

In any case it should be noted that the draft paper prepared in October is not yet finalised. The AER has requested feedback from stakeholders, so it's possible that there could be some amendments to the 'positions' proposed in the draft paper.

In its draft position paper, the AER proposes two key changes:

- Shortening the target inflation horizon from ten years to a term that matches the length of a regulatory period (typically five years).

- Applying a linear glide-path from the RBA's forecasts of inflation for years 1 and 2 to the mid-point of the inflation target band (2.5 per cent) in year 5.

While the first key change above has some merit, there is an argument against a glide path to the 2.5% mid-point at year 5. We believe it should be in year 3 (or in the year following the limit of the RBA forecasts, as set out in the 3-monthly ‘Statement on Monetary Policy). The 2.5% mid-point of the RBA target is in effect supposed to be the average rate of consumer price inflation over a ‘full economic cycle’. It also corresponds to the average of the CPI since the early 1990s, or when inflation targeting was introduced in Australia. A ‘full cycle’ is often to be considered to be around 5 years, although it could be argued that cycles could be getting longer.

Therefore, assuming 5 years is the cycle length, then the mid-point should be set for the middle of the cycle (i.e. the third year), it should not be set at year 5. As such years 3, 4 and 5 would be representative of the average target over the cycle. Note that for the third year, the year average is not necessarily 2.5%. In the RBA’s August statement, the last point for the forecast was as at December 2022. In the statement, the RBA forecasts headline CPI to ease to 1% in December 2021 and pick up slightly to at 1.25% in the June 2022 quarter (giving a year average of 1.3% for FY22), before rising to 1.5% in the December quarter 2022. Assuming a further rise over calendar 2023 to the mid-point of the RBA’s target range by December 2023, this implies a year-average CPI rate of 1.8% for FY23.

Using a methodology where the 2.5% was set for years 3,4 and 5 would yield an average of 1.89% for the five years from 2021/22 to 2025/26. This compares to the current methodology above, which yields an average of 1.93%.

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