



**BIS OXFORD  
ECONOMICS**

# **NOTE ON CHANGES TO AER TREATMENT OF INFLATION**

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

**NOVEMBER 2020**



## **BIS Oxford Economics**

Effective March 1 2017, UK-headquartered **Oxford Economics** acquired a controlling stake in **BIS Shrapnel** which had been in continuous operation since July 1, 1964 as a completely independent Australian owned firm providing industry research, analysis and forecasting services. The new organisation is now known as **BIS Oxford Economics**.

Oxford Economics was founded in 1981 as a commercial venture with Oxford University's business college to provide economic forecasting and modelling to UK companies and financial institutions. Since then, the company has become one of the world's foremost independent global advisory firms, providing reports, forecasts and analytical tools on 200 countries, 100 industrial sectors and over 3,000 cities. The company's best-of-class global economic and industry models and analytical tools provide an unparalleled ability to forecast external market trends and assess their economic, social and business impact.

Headquartered in Oxford, England, with regional centres in London, New York, and Singapore, Oxford Economics has offices across the globe in Belfast, Chicago, Dubai, Miami, Milan, Paris, Philadelphia, San Francisco, and Washington DC. Oxford Economics employs over 300 full-time people, including more than 200 professional economists, industry experts and business editors—one of the largest teams of macroeconomists and thought leadership specialists. The company's global team is highly skilled in a full range of research techniques and thought leadership capabilities, from econometric modelling, scenario framing, and economic impact analysis to market surveys, case studies, expert panels, and web analytics. Underpinning the in-house expertise is a contributor network of over 500 economists, analysts and journalists around the world.

Oxford Economics is a key adviser to corporate, financial and government decision-makers and thought leaders. The company's worldwide client base now comprises over 1000 international organisations, including leading multinational companies and financial institutions; key government bodies and trade associations; and top universities, consultancies, and think tanks.

## **November 2020**

All data shown in tables and charts are BIS Oxford Economics' own data, except where otherwise stated and cited in footnotes, and are copyright © BIS Oxford Economics Pty Ltd.

This report is confidential to **the Victorian Electricity Distribution Businesses (Jemena Electricity Networks, Citipower, Powercor Australia Ltd, AusNet Services and United Energy Ltd)** and may not be published or distributed without their prior written permission.

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.

To discuss the report further please contact:

## **Richard Robinson**

[REDACTED]

BIS Oxford Economics Pty Limited  
Level 8, 99 Walker Street  
North Sydney NSW 2060  
Australia

[REDACTED]

# 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 in the main BISOE report 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					
<b>NOMINAL PRICE CHANGES</b>												
<b>1. Internal Electricity Network-Related Labour</b>												
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
<b>2. General Wages</b>												
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
<b>REAL PRICE CHANGES (e)</b>												
<b>1. Internal Electricity Network-Related Labour</b>												
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
<b>2. General Wages</b>												
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. However, should the AER’s draft position be adopted, the next section provides an amended Labour escalation forecast with the lower CPI inflation forecast that would flow from this change.

## Amended Labour Escalation Forecasts Using Revised AER Position

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.

In the table below, we provide an amended forecast passed on the AER's proposed methodology.

**Table 1.2 Summary Table – Labour Cost Escalation Forecasts for Victoria and Australia – including Impact of Proposed Superannuation Guarantee Increases AND revised Inflation Methodology (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					
<b>NOMINAL PRICE CHANGES</b>												
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. External Contractor Labour Cost Escalation												
Construction WPI - Victoria (d)	2.5	2.8	1.8	2.4	2.2	0.8	1.2	1.7	2.3	2.9	2.9	2.2
Construction WPI - Australia (b)	1.6	1.7	1.9	1.9	1.5	0.7	1.3	1.8	2.4	2.8	2.9	2.2
3. 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	1.7	1.9	1.9	1.9	1.75
<b>REAL PRICE CHANGES (e)</b>												
1. Internal Electricity Network-Related Labour												
EGWWS WPI - Victoria	1.9	1.2	0.9	1.4	1.9	0.8	0.8	0.7	0.9	1.1	1.1	0.9
EGWWS WPI - Australia	1.0	0.5	0.0	1.1	1.3	0.4	0.6	0.6	0.8	1.0	1.0	0.8
2. External Contractor Labour Cost Escalation												
Construction WPI - Victoria	1.1	1.1	-0.1	0.7	0.9	-0.7	-0.1	0.0	0.4	0.9	1.0	0.4
Construction WPI - Australia	0.2	0.0	-0.1	0.2	0.2	-0.8	0.0	0.2	0.5	0.9	1.0	0.5
3. General Wages												
Victoria WPI	1.0	0.2	0.4	1.0	1.1	-0.6	-0.1	0.0	0.3	0.6	0.6	0.3
Australia All Industries - WPI (b)	0.7	0.2	0.1	0.7	0.8	-0.3	0.0	0.1	0.4	0.6	0.6	0.3

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. AWOTE is average weekly ordinary time earnings for full time adult persons, where overtime payments are excluded but bonus payments are included

(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 a glide-path to the mid-point of RBA inflation target (2.5%) by year 5. The overall forecasts are then calculated as a geometric mean of the 'official' RBA inflation forecasts over the next 5 years or to the end of the regulatory period, with years 3,4 and 5 CPI equal to the calculated 5-year geometric mean. This methodology has been proposed (but yet adopted) by the AER in its Draft position paper of October 2020.

(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.



OXFORD  
ECONOMICS

**Global headquarters**

Oxford Economics Ltd  
Abbey House  
121 St Aldates  
Oxford, OX1 1HB  
UK  
**Tel:** +44 (0)1865 268900

**London**

Broadwall House  
21 Broadwall  
London, SE1 9PL  
UK  
**Tel:** +44 (0)203 910 8000

**New York**

5 Hanover Square, 8th Floor  
New York, NY 10004  
USA  
**Tel:** +1 (646) 786 1879

**Singapore**

6 Battery Road  
#38-05  
Singapore 049909  
**Tel:** +65 6850 0110

**Europe, Middle East  
and Africa**

Oxford  
London  
Belfast  
Frankfurt  
Paris  
Milan  
Cape Town  
Dubai

**Americas**

New York  
Philadelphia  
Mexico City  
Boston  
Chicago  
Los Angeles  
Toronto  
San Francisco  
Houston

**Asia Pacific**

Singapore  
Sydney  
Hong Kong  
Tokyo

**Email:**

[mailbox@oxfordeconomics.com](mailto:mailbox@oxfordeconomics.com)

**Website:**

[www.oxfordeconomics.com](http://www.oxfordeconomics.com)