



# Jemena Electricity Networks (Vic) Ltd

## 2021-26 Electricity Distribution Price Review Revised Proposal

Attachment 05-03

BISOE Note on changes to AER treatment of inflation (addendum)





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

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

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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 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.



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