



# ATTACHMENT 09.001 AA6 LABOUR AND COST ESCALATION FORECAST

ATCO PLAN 2025-29

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# **ATCO Gas Australia cost escalation forecasts for the AA6 regulatory period**

A report prepared for ATCO Gas Australia

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## Executive Summary

ATCO Gas Australia (ATCO) is developing its sixth Access Arrangement proposal (AA6 Proposal) to be submitted to the Economic Regulation Authority (ERA) in September 2023.

As part of the AA6 Proposal, Synergies has been engaged by ATCO to develop the following forecast cost escalators for its AA5 submission relating to the 2025-29 regulatory period:

- CPI
- Real labour cost escalation for the Energy, Gas, Water and Waste Services sector (WPI EGWWS)
- Real materials cost escalation.

Synergies has taken note of ERA's past forecasting approaches in respect of these escalators in developing the AA6 forecasts. In this regard, we have adopted ERA's approaches for CPI and real materials escalators, but proposed a different estimation methodology for real labour escalation that uses all forecast WPI and CPI inputs. In contrast, the first year of ERA's methodology requires use of actual (2022/23) WPI and CPI data, which we think are unlikely to be representative of growth in these variables in the AA6 regulatory period.

### **Economic conditions impacting cost escalation in AA6 period**

It is important to note that this is a particularly challenging time to develop CPI, labour and materials escalation forecasts given the widespread emergence in the last two to three years of strong inflationary pressures in major international economies including the Australian economy.

This has necessitated central banks, including the Reserve Bank of Australia (RBA), sharply increasing their cash rates with impacts across the interest rate yield curve. The impact of these rate rises on economic activity, including growth, demand, labour and materials markets, is yet to be fully revealed. A further tightening of monetary policy in Australia is still possible notwithstanding the latest increase in the cash rate in June 2023.

For Western Australia, global and national macroeconomic conditions will strongly influence the local economic outlook, including due to their effect on WA's significant iron ore and LNG exports. It is expected that current levels of economic growth and employment in Western Australia will moderate over the next few years as a result of

higher interest rates designed to slow domestic and international economies and in so doing bring inflation under control.

However, it is not clear that current tight labour market conditions in Western Australia or East Coast Australia will ease quickly, with the ABS Wage Price Index All Industries series currently showing the strongest year-on-year growth in over a decade at just under 4.0% in the March quarter 2023.

## AA6 cost escalator forecasts

### CPI forecast

We have adopted what is generally known as the ‘break-even’ CPI forecasting method and applied it in accordance with ERA’s Rate of Return Guideline.

This method reflects the difference between nominal and index-linked Commonwealth Government long-term bond yields and provides a market-based forecast of inflation. Evidence suggests that over time this has been more reliable than alternative methodologies used by other Australian economic regulators.

In accordance with ERA’s 2022 Gas Rate of Return Instrument, we have used 5-year nominal and inflation-linked bonds that match the term of the AA6 regulatory period.<sup>1</sup> Our breakeven forecast is calculated using reported bond data in the 20 days to 30 June 2023. The bonds we have used are presented in Table 1.

**Table 1 Commonwealth Government bond data used in breakeven calculation**

Bond issue	Maturity date	Type of bond	Current yield
Treasury Bond 148	21 November 2027	5-yr Nominal	3.84%
Treasury Bond 149	21 May 2028	5-yr Nominal	3.84%
Treasury Bond 414	21 November 2027	5-yr Indexed	1.14%
Treasury Bond 408	30 September 2030	5-yr Indexed	1.32%

Source: Yieldbroker

Applying the breakeven methodology, the implied 5-yr breakeven CPI forecast for the AA6 period at 30 June 2023 is **2.67%** based on a nominal bond yield of 3.88% and real bond yield of 1.18%.

<sup>1</sup> Bond yield data was sourced from Yieldbroker. We have used Yieldbroker data because the RBA no longer publishes the bond data required for this forecast calculation. We are aware that ERA is proposing to use Bloomberg data in its updated 2022 Gas Rate of Return Instrument. ERA’s analysis found that the Bloomberg and Yieldbroker bond data sets provided very similar results.

<https://www.erawa.com.au/cproot/23395/2/Proposed-amendments-to-2022-Gas-Rate-of-Return-Instrument-for-data-source-cessation.PDF>

We expect ERA will require ATCO to update this CPI forecast after the release of its Draft Determination so that a more up-to-date forecast is used for ATCO’s AA6 regulatory period given the potential for market inflation expectations to change between now and then.

## Real labour cost escalation forecast

We have adjusted somewhat ERA’s preferred forecasting methodology to calculate an alternative AA6 real labour cost forecast based on a four year average of WA Treasury CPI and WPI forecasts from 2023/24 to 2026/27 rather than a five year average forecast (which would include 2022/23 in the calculation).

We have removed WA Treasury’s 2022/23 estimated actual CPI figure from our calculation because at 5.75% we do not consider it to be representative of expected CPI growth in the AA6 regulatory period. Our four year WPI All Industries forecast is 3.50% and CPI forecast is 2.81% based on WA Treasury’s May 2023 Update of Economic Forecasts.<sup>2</sup>

We have then calculated the average premium of the EGWWS WPI over the All Industries WPI series from 2000 to 2022 to be 0.40%. We consider an EGWWS premium of this size is appropriate based on long term historical reported WPI All Industries and WPI EGWWS data and our expectation that there will likely be strong demand for EGWWS workers in the AA6 period given significant announced energy and water infrastructure construction across Australia. We applied this to the WPI All Industries forecast before deflating this nominal EGWWS forecast by the WA Treasury average CPI inflation forecast.

These inputs are used to calculate the EGWWS real labour cost AA6 forecast shown in Table 2.

**Table 2 Real labour cost escalation inputs and outcome**

Bond issue	Current yield
Annual average of WA All Industries WPI	3.50%
Plus premium of EGWWS WPI on All Industries WPI	0.40%
Equals nominal labour escalation forecast per year	3.54%
Less forecast CPI inflation per annum	2.81%
Equals labour escalation	1.06%

Source: Synergies using WA Treasury forecasts for WA All Industries and CPI inflation

<sup>2</sup> [https://www.wa.gov.au/system/files/2023-05/economic-forecasts\\_0.pdf](https://www.wa.gov.au/system/files/2023-05/economic-forecasts_0.pdf)

We propose that the real labour cost escalation forecast for the AA6 regulatory period is **1.06%**.

We do not consider our adjustment to ERA's preferred forecasting methodology to be especially contentious. Removing the 2022/23 estimated actual inflation from the calculation can be justified on the grounds that at 5.75% it is significantly out of line with both WA Treasury's latest CPI forecasts (average four year growth of 2.81%), which extend to 2026/27 and the forward-looking breakeven CPI inflation estimate calculated above which is currently 2.67%. Our calculation also removes the WA Treasury 2022/23 estimated actual WPI All Industries forecast to ensure both the CPI and WPI forecasts are based on four year averages.

## **Real materials cost escalation forecast**

The development of economically and statistically meaningful forecasts of material escalators using indices other than CPI and that would be relevant to ATCO's opex base step trend forecast is challenging, primarily because of the absence of a gas network-specific materials index.

Given the relatively small proportion of materials in ATCO's opex and the limited availability of fit-for-purpose Producer Price Index (PPI) and CPI sub-component escalators, as well as the absence of any reliable 5 year forecasts for the PPI and CPI sub-component indices, we do not think it is feasible to develop materials cost escalator forecasts that could be relied upon.

Consequently, our recommendation is for zero real growth for materials escalation in the AA6 regulatory period, which is the approach adopted by ERA in its AA5 Final Determination.

However, we recommend that any materials opex sub-categories that ATCO is concerned may differ considerably from CPI forecast growth in the AA6 period should be removed from the opex base step trend calculation and be subject to a ground-up cost calculation.

## **Opex productivity factor forecast**

Recognising ERA's approach to determining an opex productivity assumption for the current (AA5) regulatory period, we have confirmed with ATCO that its proposed capex forecasts in the AA6 regulatory period are principally sustaining and network growth projects, which are unlikely to influence opex productivity in any material way. This is essentially the same capex profile that ATCO is implementing in the current regulatory period.

We have also confirmed with ATCO that its AA6 forecasts regarding the growth/scale drivers of connections numbers and gas throughput, in aggregate, are weak and as such are unlikely to materially drive improvements in ATCO's opex productivity in the AA6 regulatory period:

Rather than incorporating a forecast of opex productivity improvement in the AA6 opex forecast given these unsupportive forecast capex and growth/scale factors, ATCO's past opex productivity performance suggests it will, to the extent possible, seek out opex productivity improvements that will ultimately be to the long term benefit of ATCO's gas consumers.

Consequently, our recommendation is for zero opex productivity growth in the AA6 regulatory period, which is the approach adopted by ERA in its AA5 Final Decision.

## Recommendations

Our proposed cost escalators and opex productivity forecasts for ATCO's AA6 regulatory period are presented in Table 3.

**Table 3 AA6 cost escalation forecasts**

Variable	CY25	CY26	CY27	CY28	CY29	AA5 forecast average
CPI – Australia (breakeven method)	2.67%	2.67%	2.67%	2.67%	2.67%	2.67%
WA Treasury CPI used in real WPI calculation	2.81%	2.81%	2.81%	2.81%	2.81%	2.81%
Real WPI – EGWWS	1.06%	1.06%	1.06%	1.06%	1.06%	1.06%
Real materials escalation	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Opex productivity factor	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

**Note:** CPI means Consumer Price Index; WPI means Wage Price Index; and EGWWS means Electricity, Gas, Water and Waste Services

**Source:** Synergies



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# 1 Introduction

ATCO has engaged Synergies Economic Consulting (Synergies) to develop forecasts for the following cost escalators for the AA6 regulatory period from CY 2025 to CY2029:

- CPI
- Real labour cost escalation.
- Real materials cost escalation
- Operating cost (opex) productivity.

The remainder of this report is structured as follows:

- Section 2 provides an analysis of expected economic trends internationally, in Australia and WA in the medium term.
- Section 3 presents our AA6 CPI forecast applying the 'breakeven' methodology.
- Section 4 presents our AA6 real labour cost forecasts derived by applying an amended version of ERA's preferred forecasting methodology.
- Section 5 presents our AA6 real materials forecast plus commentary on the challenges developing robust representative materials cost escalation forecasts.
- Section 6 presents our AA6 opex productivity factor forecast.

## 2 Recent macroeconomic developments

In early 2022, there were signs globally of increasing inflationary pressures as economies emerged from the Covid-19 pandemic. Since then, inflationary pressures have increased significantly, both globally and in Australia. Central banks in all major economies have tightened monetary policy sharply, resulting in rapidly rising interest rates.

According to the International Monetary Fund (IMF), most economies remain focussed on achieving sustained reductions in inflation. The rate at which interest rates have been increasing since early 2022 appears to be slowing, including in Australia. The timing of interest rate increases flattening, and perhaps beginning to decline, will fundamentally depend on how quickly current global inflationary pressures ease.

### 2.1 International developments

In developing cost escalation forecasts for ATCO's AA6 regulatory period, international developments are likely to have the biggest influence on Australian and WA CPI and materials costs. This is primarily due to imported inflation embodied in the import of goods and services, including the materials and equipment that ATCO purchases in the AA6 period to deliver its regulated gas distribution services.

In contrast, the strength of the economies of Australia's and WA's main international trading partners will influence demand for Australian exports affecting the strength of labour markets in trade-exposed sectors. This in turn will flow through to domestic sectors requiring workers with comparable skillsets to those in trade-exposed sectors. Furthermore, this will ultimately affect the cost of labour, including ATCO's AA6 labour costs, given Electricity, Gas, Water and Waste Services (EGWWS) workers have broadly overlapping skillsets with workers employed in the WA iron ore sector.

#### 2.1.1 International inflationary pressures remain strong

In 2022 in the United States and some European countries, inflation reached its highest level in more than forty years, with less optimistic economic outlooks than previously expected. Recent stress on the international banking sector elevated the risk of recession in advanced economies.<sup>3</sup>

More recently, there has been some easing of inflationary pressures in response to central banks sharply increasing short term interest rates. The RBA in its May 2023 Statement of Monetary Policy stated:<sup>4</sup>

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<sup>3</sup> Commonwealth Department of Treasury 2023-24, Budget Papers Statement 2, Economic Outlook, p 39.

<sup>4</sup> RBA (2023), Statement on Monetary Policy, May 2023, p 5

Although headline inflation is past its peak in most advanced economies and in much of east Asia, progress in reducing core inflation has slowed in recent months.

In terms of the economic impact of the international monetary policy tightening, the RBA recently noted the following:<sup>5</sup>

Unemployment rates remain very low and labour markets are tight, but less so than a few months ago. Economic growth in advanced economies has slowed in response to higher interest rates but by less than had been expected.

The WA Treasury Corporation similarly found in its Second Quarter 2023 Newsletter:<sup>6</sup>

The global economy has continued to show resilience to ongoing monetary tightening by central banks.

Nevertheless, across the globe there exists a complex mix of economic and political factors, resulting in a high degree of uncertainty about the international economy and associated forecasts for key macroeconomic variables.

The RBA's May 2023 Statement on Monetary Policy recognised this uncertainty as follows:<sup>7</sup>

The pace of disinflation is uncertain, resulting in greater-than-usual uncertainty about the outlook for monetary policy. Monetary policy transmission is uncertain, both in terms of lags and the overall effect on output and inflation.

..... it is possible that inflation could slow more quickly than expected, particularly as there may be further disinflationary pressures on final goods prices. The risk of spillovers to global goods inflation from the Chinese economy's reopening is judged to be low at this stage, given supply chain issues have dissipated, and goods demand in China remains weak.

Overall, we consider the international outlook is that the worst of inflationary pressures are most likely over. However, there will be no quick return to the low inflation environment experienced for many years prior to Covid-19 emerging. This suggests that ATCO will continue to experience international inflationary pressures in AA6 primarily through its purchase of imported materials and equipment.

ATCO's labour costs are also likely to be affected by the strong international demand for workers across the US and Western economies arising from energy decarbonisation and

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<sup>5</sup> RBA (2023), Statement on Monetary Policy, p 5

<sup>6</sup> WA Treasury Corporation (2023)2023, Newsletter, Second Quarter 2023, p 3

<sup>7</sup> RBA (2023), Statement on Monetary Policy, p 13

the associated significant renewable energy infrastructure build that is planned in the next decade to meet governments' net zero commitments.

## **2.2 Domestic developments**

Despite continuing uncertainties about the global outlook, Australia's underlying economic recovery from the Covid-induced downturn has exceeded expectations. Federal Treasury considers there is generally strong future economic outlook albeit with risk of a downturn as the RBA lifts interest rates to dampen inflationary pressures in the economy.<sup>8</sup>

In 2022, consumer price inflation rose by 7.8%. This growth in inflation was driven by numerous domestic and international factors. In 2023, inflation is expected to ease, with international factors contributing to higher inflation expected to weaken somewhat through the year. Labour markets are expected to remain resilient despite softer domestic household consumption reflected in stronger wages growth than in recent preceding years.<sup>9</sup>

### **2.2.1 Australian GDP growth outlook**

In its May 2023 Budget, Federal Treasury forecast real GDP growth of 3.25% in 2022-23, before falling back to 1.5% in 2023-24 as shown in Figure 1. The decrease in real GDP growth can be attributed to international factors affecting the domestic economy through rising interest rates and high inflation which have dampened household consumption and investment in construction.<sup>10</sup>

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<sup>8</sup> International Monetary Fund (2023), World Economic Outlook, January, p 56.

<sup>9</sup> International Monetary Fund (2023), World Economic Outlook, January, p 71.

<sup>10</sup> International Monetary Fund (2023), World Economic Outlook, January, p 56.

**Figure 1 Australian actual and forecast GDP growth – 2011-12 to 2024-25**



Data source: Commonwealth Department of Treasury; RBA; IMF

Inflation in Australia appears to have peaked in 2022, coincident with international supply constraints that are now easing. Along with renewed population growth and increased investment in construction, particularly with respect to new housing, Treasury has forecast real GDP growth of 2.25% in 2024-25.<sup>11</sup> This recovery in economic growth is expected to be supported by improved conditions for mining and rural exports.

### 2.2.2 Labour market

Despite an expected decline in growth of the domestic economy in 2023-24, labour markets are expected to remain resilient. Federal Treasury expects unemployment to remain at very low historical lows of 4.25% in June 2024 and 4.5% in June 2025, up from the current rate almost 50-year low of 3.5%.<sup>12</sup>

Reflecting this tight labour market, while real wages are still falling given CPI inflation remains at a high level, they are expected to rise once inflation moderates. Real wage growth is expected to resume in 2024.<sup>13</sup>

Similarly, the RBA also anticipates that over the next few years the labour market will moderate from very tight conditions at present. A pickup in net arrivals from overseas

<sup>11</sup> International Monetary Fund (2023), World Economic Outlook, January, p 58.

<sup>12</sup> RBA (2023), Statement on Monetary Policy, p 1

<sup>13</sup> Commonwealth Department of Treasury, 2023-24, Budget Papers Statement 1, Economic Outlook, p 71.

is expected to partially alleviate current workforce shortages. However, demand for labour will remain strong into 2025 driven by a high workforce participation rate.<sup>14</sup>

In our view, it appears reasonable to assume that while general labour market conditions in WA and Australia may ease somewhat in the AA6 period, demand for skilled workers in the energy and water infrastructure sectors is likely to remain strong given Australian and global significant forecast infrastructure expenditure associated with energy decarbonisation over at least the next decade.

The Australian Government's Department of Climate Change, Energy, Environment and Water, commented on this issue as follows:<sup>15</sup>

Much of the work required to implement the transition to net zero draws on a limited workforce, both within Australia and globally. Australia must also ensure there is a pipeline of skill transfer and training to give the sector the workforce it needs into the future.

### **2.2.3 Consumer and business confidence**

Australian household consumption rebounded in 2022-23 as the effects of Covid-19 unwound and associated pent-up demand for goods and services was released. However, this increase in demand will be dampened in 2023-24 by higher interest rates and cost of living pressures. Federal Treasury anticipated a return to growth in household consumption of around 2.5% in 2024-25 (and onwards) but notes these forecasts are subject to significant uncertainty. While some households have the capacity for continuing spending, others without savings may have to reduce discretionary spending, with the overall outcome uncertain.<sup>16</sup>

Business investment is expected to remain relatively steady, growing by 3% in 2022-23 and by 2.5% and 2% over the subsequent two years. Non-mining investment, and in particular construction projects, is underpinning investment through these years.<sup>17</sup>

### **2.2.4 Wages and inflation**

Domestic price inflation reached 7.8% (year on year) in December 2022. Global factors were the main contributor to higher domestic inflation and those factors are expected to ease in coming years. Domestic energy prices and the impact of floods affecting the

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<sup>14</sup> <https://www.rba.gov.au/publications/smp/2023/feb/domestic-economic-conditions.html>

<sup>15</sup> <https://www.energy.gov.au/government-priorities/energy-workforce>

<sup>16</sup> Commonwealth Department of Treasury, 2023-24, Budget Papers Statement 2, Economic Outlook, p 61.

<sup>17</sup> International Monetary Fund (2023), World Economic Outlook, p63.



availability and hence price of fresh food were also inflationary factors in 2022. As with the global factors affecting inflation, domestic causes of price increases are expected to ease in coming years. As a result, annual inflation, which is expected to be 6% in 2022-23, is forecast to fall to 3.25% in 2023-24 and 2.75% in 2024-25.<sup>18</sup>

Unemployment remains at 50-year lows in Australia. Unemployment by the end of June 2023 is expected to be 3.5%, before rising moderately in 2023-34 to 4.25% and then 4.5% in 2024-25. Federal Treasury noted that no wage-price spiral is evident yet.<sup>19</sup> However, higher inflation rates are being accompanied by higher nominal wage growth forecasts at around 3.75% in the current year and 4% expected in 2023-24. As inflation is forecast to recede in 2024, real wage growth is expected to return in 2024.<sup>20</sup>

These higher wage forecasts have been supported by the release of the ABS WPI series for the March quarter 2023. Seasonally adjusted private sector wages rose 0.8% over the quarter, resulting in annual growth of 3.8%. This is the highest recorded annual growth since June quarter 2012. Similarly, public sector wages rose 0.9% over the quarter, resulting in annual growth of 3.0%. This is the highest annual growth since the March quarter 2013. As discussed in Section 4 of our report, this strengthening in wages growth has also been reflected in the EGWWS sector which is of most relevance to ATCO.

### **2.2.5 Commodity prices**

One of the main consequences of recent adverse global events has been a sharp uplift in commodity prices, which has benefited several of Australian commodity exports, particularly base metals (including iron ore), thermal and coking coal. In April 2023, the RBA's index of commodity prices (ICP) was up 46% compared with December 2020.

However, Federal Treasury anticipates a return to longer term trends in commodity prices, with prices expected to return to trend in a year, albeit acknowledging these forecasts are intentionally conservative and below most market expectations.<sup>21</sup>

Recognising their importance to economic activity in the WA economy, iron ore prices are expected to moderate from the Covid-19-related highs in 2021, but international demand for iron ore, including from China, is expected to remain reasonably strong over the next decade with Australian exports growing by around 3% per annum.<sup>22</sup>

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<sup>18</sup> International Monetary Fund (2023), World Economic Outlook, p65.

<sup>19</sup> International Monetary Fund (2023), World Economic Outlook, p71.

<sup>20</sup> International Monetary Fund (2023), World Economic Outlook, p72.

<sup>21</sup> Commonwealth Department of Treasury, 2023-24, Budget Papers Statement 2, Economic Outlook, p74.

<sup>22</sup> Australian Government (2023), Department of Industry Science and Resources, Office of the Chief Economist, Resources Outlook, (March), p 42

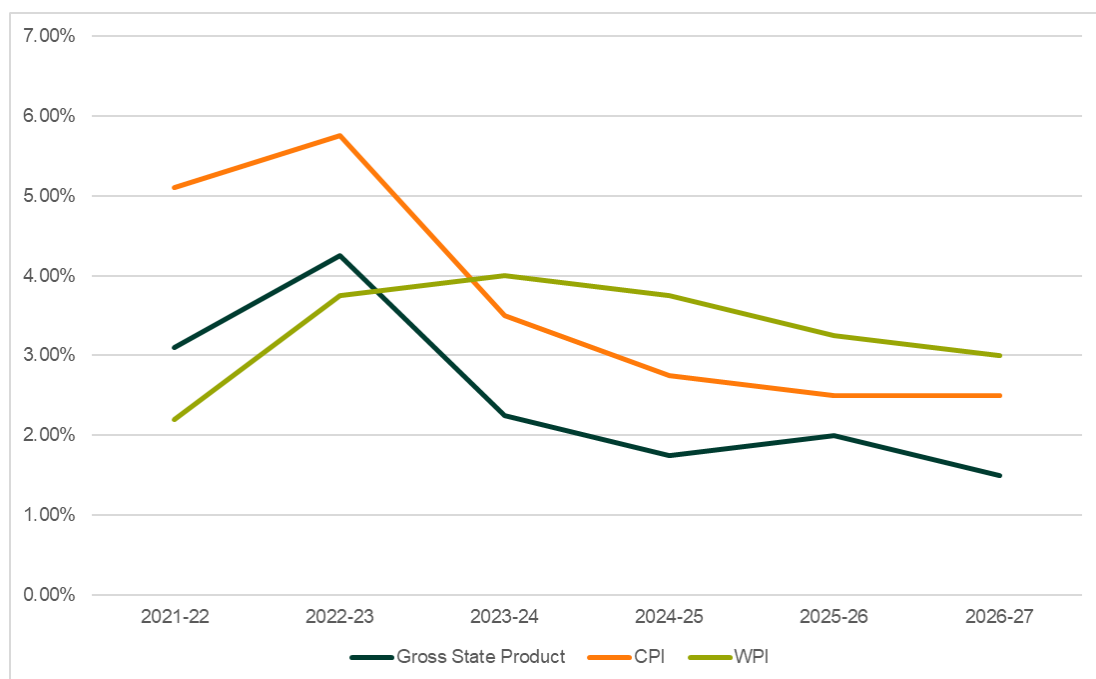
## 2.3 Developments in WA

The Western Australian economy has performed strongly over the past few years despite the difficulties posed by the COVID-19 pandemic.

Gross State Product (GSP) grew by an expected 4.25% in 2022-23, driven by higher earnings from commodity exports. In 2023-24, growth is expected to moderate slightly to 2.25% as households ease spending in response to higher interest rates and exports return to more normal levels.

As shown in Figure 2, growth is expected to be around 1.75% and remain at around that rate in 2024-25 and subsequent years.<sup>23</sup> Importantly, WPI (All Industries) growth is expected to exceed CPI growth from 2024/25 to 2026/27.

**Figure 2 WA Department of Treasury economic forecasts**



Data source: WA Department of Treasury; Western Australia State Budget – Budget Papers

Elevated growth and commodity prices combined to deliver a 2022-23 government operating surplus estimated at \$4.2 billion, reducing net debt levels to \$29.4 billion. Weak economic growth in the UK and Europe, along with a possible recession in the US, could impact on the Western Australian economy as key economies throughout the world experience subdued economic conditions. The Western Australian Treasury expects the

<sup>23</sup> Western Australian Government, State Budget 2023-24, Economic and Fiscal Outlook, p2.

re-opening of international borders to services imports (such as Western Australians travelling overseas) is likely to moderate the growth in GSP over the coming two years.

Very strong growth in Western Australian consumer spending at just over 5% was recorded in 2021-22. However, consumer spending is expected to ease 2% in 2022-23 and improve only modestly in 2023-24 to 2.5% and in subsequent years. These lower rates of spending reflect the lagged effect of higher interest rate increases, moderated by the highest rate of household savings (28.2% in 2021-22) compared with the rest of the domestic economy (at 21.8%).

The strength of the Western Australian economy in recent years has underpinned tight labour market conditions at present. This is reflected in high labour force participation, elevated job vacancies, record levels of total hours worked and low unemployment (3.4% in October 2022). According to the WA Treasury, the labour market is experiencing limited spare capacity, primarily driven by demand for labour in the resources sector. However, these conditions will moderate over the next few years due to slower growth in the domestic economy, including Western Australia.<sup>24</sup>

The average unemployment rate in Western Australia in 2022-23 is estimated to be 3.5%, which is the lowest since 2008-09. In 2023-24, unemployment is forecast to rise to 4%, and then to 4.5% by 2025-56 as labour demand is outpaced by migration from overseas. Meanwhile, wage growth is forecast to be 3.75% in 2022-23 and 4% in 2023-24 due to the tight labour market conditions.<sup>25</sup>

Moderating domestic economic conditions and a decline in the influence of global and national adverse events is expected to see a softening of inflation in the Western Australian economy. WA Treasury now expects the Perth Consumer Price Index (CPI) to grow by 5.75% in 2022-23 but moderate quickly to 3.5% in 2023-24 as supply side pressures begin to ease.<sup>26</sup>

## **2.4 Conclusion**

Macroeconomic conditions internationally and in Australia are emerging from a very challenging period.

Of most concern in recent years has been the widespread emergence of strong inflationary pressures, which has necessitated central banks globally increasing interest rates. Key to the immediate outlook will be the RBA's interest rate decisions that have

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<sup>24</sup> Western Australian Government, Government Mid-year Financial Projections Statement 2022-23, December 2022, p44.

<sup>25</sup> Western Australian Government, State Budget 2023-24, Economic and Fiscal Outlook, p16.

<sup>26</sup> [https://www.wa.gov.au/system/files/2023-05/economic-forecasts\\_0.pdf](https://www.wa.gov.au/system/files/2023-05/economic-forecasts_0.pdf)

seen monetary policy tightened to bring inflation down. Some further tightening of monetary policy is possible. However, we appear to be nearing an end to rising interest rates in this tightening cycle.

For Western Australia, the state economy is expected to follow a similar path to the global and national macroeconomic trends. That is, current strong current levels of economic growth, employment and prices will moderate as a result of higher interest rates designed to bring inflation under control. However, there remain many uncertainties around medium term economic growth, labour market, wage and price forecasts, both with respect to the global economy and domestically.

The main implication of this international and domestic economic outlook for ATCO in the AA6 regulatory period is that inflationary pressures in relation to CPI, labour, materials and equipment will ease somewhat from current high levels but remain elevated compared to the pre-Covid-19 period.

### 3 CPI Forecast

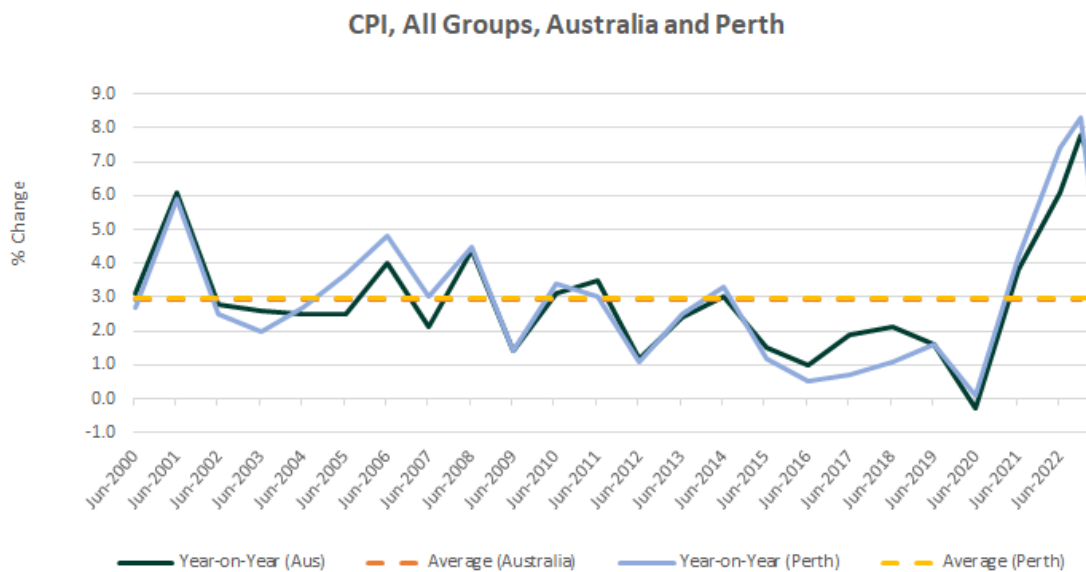
The purpose of this section is to present our annual CPI forecasts for ATCO’s AA6 regulatory period.

#### 3.1 Background

Figure 3 shows historical movements in CPI for both Australia and Perth since 2000. Over this timeframe, CPI movements averaged 2.90% for both Perth and Australia (All capitals).

The rate of CPI inflation is currently well above its long-run average since 2000. What Figure 3 makes clear though is that the recent sharp increase in CPI has been more pronounced in Perth than in the rest of Australia. In particular, the year-on-year growth to December 2022 was 8.3% for Perth, compared to 7.8% for Australia as a whole. However, in the March quarter 2023, year-on-year CPI growth in Perth was 5.8%, which was somewhat lower than year-on-year growth for Australia of 7.8%.

**Figure 3 Historical CPI movements in Australia and Perth**



Data source: ABS CPI Series

#### 3.2 Breakeven CPI forecasting methodology

Our annual CPI inflation forecasts are based on applying the break-even methodology for 5-year and 10-year time horizons.

ERA’s Rate of Return Guideline requires an inflation forecast that is aligned in term to the relevant 5-year regulatory period. The 10-year forecast is presented for completeness.

Our breakeven forecast is calculated using reported nominal and indexed bond data in the 20 days to 30 June 2023. The Commonwealth bonds we have used in our calculation are presented in Table 4.

**Table 4 Commonwealth bond Input data for breakeven calculation**

Bond issue	Maturity date	Type of bond	June 2023 yield
Treasury Bond 148	21 November 2027	5-yr Nominal	3.84%
Treasury Bond 149	21 May 2028	5-yr Nominal	3.84%
Treasury Bond 414	21 November 2027	5-yr Indexed	1.14%
Treasury Bond 408	30 September 2030	5-yr Indexed	1.32%

Source: Yieldbroker

### 3.3 Our recommendation

The implied 5-year breakeven CPI forecast as at 30 June 2023 is **2.67%** based on a nominal bond yield of 3.88% and real bond yield of 1.18%.

Table 5 presents our recommended CPI forecast for the for the AA6 regulatory period.

**Table 5 AA6 CPI forecasts**

	CY2025	CY2026	CY2027	CY2028	CY2029
CPI	2.67%	2.67%	2.67%	2.67%	2.67%

Source: Synergies

We consider that for the reasons outlined in this Section 3, this recommendation is consistent with Clause 74(2) of the National Gas Rules, which requires that it must be arrived at on a reasonable basis and must represent the best forecast or estimate possible in the circumstances.

## 4 Real labour escalation forecasts

The purpose of this section is to present our WPI-based Electricity Gas Water and Waste Services (EGWWS) forecasts for ATCO's AA6 regulatory period,

### 4.1 Our forecasting approach

We have estimated WPI and the real labour cost escalation factor using a similar approach to that which ERA usually applies, including for ATCO's current (AA5) regulatory period.

ERA's usual approach to the determination of the real labour escalation forecast consists of five steps:<sup>27</sup>

1. Estimating WA WPI for the regulatory period based on an average of latest WA Treasury forecasts including the most recent actual (or near actual) year. For the AA6 forecast, this would be 2022/23, with the other four years based on WA Treasury forecasts from 2023/24 to 2026/27.
2. Estimating the premium (if any) of EGWWS WPI over the Australian All Industries WPI.
3. Adding together the WA WPI forecast and the EGWWS premium to derive the nominal labour cost escalation forecast.
4. Estimating forecast CPI using WA Treasury forecasts using the same method applied for estimating WA WPI All Industries forecasts (in Step 1).
5. Deducting the CPI forecast from the nominal labour cost escalation forecast to derive the real labour (real WPI) cost escalation forecast.

In contrast, we have amended our application of ERA's approach at Steps 1 and 4 by only using WA Treasury forecasts from 2023/24 to 2026/27 excluding 2022/23 in our calculation. Our amended approach is explained further in section 4.2 below.

### 4.2 Our AA6 real labour cost forecasts

We apply each of ERA's five steps, as amended for Steps 1 and 4, to develop our real WPI EGWWS forecasts for the AA6 regulatory period.

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<sup>27</sup> ERA (2018). Final decision on proposed revisions to the access arrangement for the Western Power network 2017/12-2021/22, 20 September, p.100.

#### 4.2.1 Step 1: Western Australian WPI forecast

We have used the WA Treasury 2023/24 Budget forecasts for WPI All Industries for 2023/24 to 2026/27 to calculate a four year average forecast of 3.50% as shown in Table 6.

**Table 6 WPI growth estimate based on ERA approach**

	2023/24 Budget Year	2024-25 Outyear	2025-26 Outyear	2026-27 Outyear	Average
WPI growth	4.00%	3.75%	3.25%	3.00%	3.50%

Source: WA Treasury Economic Forecasts – Major Economic Aggregates

Based on our understanding of the WA Treasury Budget forecasts, we consider that these WPI All Industries forecasts do not include the effect of the Commonwealth Government increases (by 0.5% each year) in the legislated superannuation rate until it reaches 12% on 1 July 2025.

#### 4.2.2 Step 2: Estimated premium of EGWWS WPI over Australian All Industries growth estimate

For Western Power’s AA5 regulatory period, the ERA allowed an EGWWS premium of 0.1% based on the most recent data available. The ERA did not apply an EGWWS premium in its AA5 decision for ATCO because it did not submit a non-zero productivity factor offsetting the wage growth forecast.

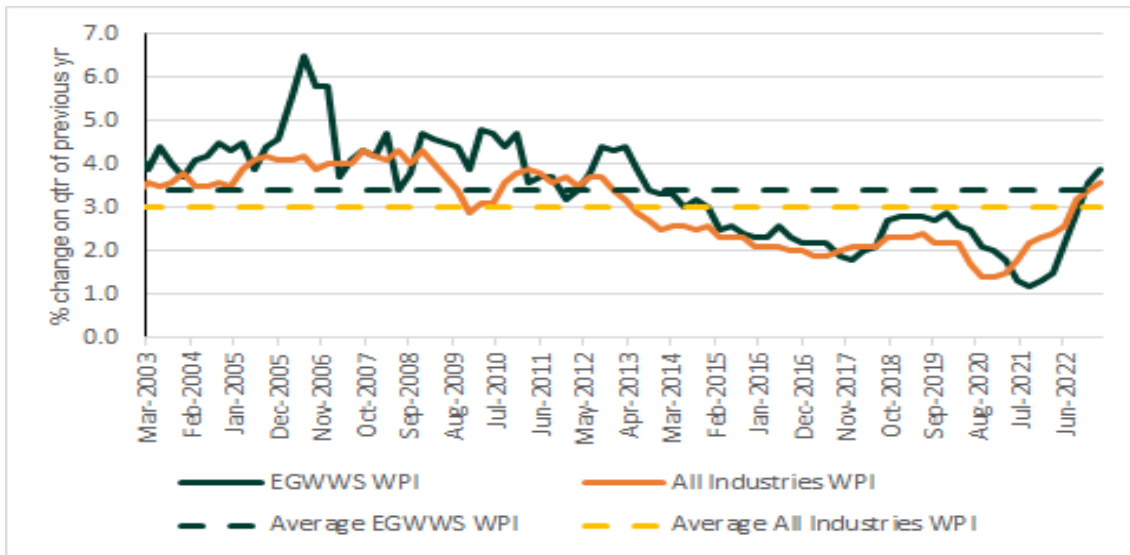
Further, ERA argued that a business with productivity growth should not just automatically include an industry real wage premium as a result of a productivity factor being applied to expenditure.<sup>28</sup>

Figure 4 shows the percentage change from corresponding quarter of previous year growth in the EGWWS WPI and All Industries WPI since 2003. In the March quarter 2023, EGWWS WPI grew by 3.90% and All Industries WPI grew by 3.60%. The 20 year average for EGWWS WPI is 3.43% and for All Industries WPI is 3.03%.

<sup>28</sup> ERA (2019), Final Decision on proposed revisions to the Mid-West and South-West Gas Distribution Systems access arrangement for 2020 to 2024, (November), p 144



**Figure 4 Annual quarterly movements in EGWWS WPI and All Industries WPI**



Source: ABS, Synergies calculations

Estimates of the EGWWS premium for averaging periods of 5, 10, 15 and 20 years are shown in Table 7.

**Table 7 EGWWS WPI growth premium over Australian All Industries WPI over time**

Averaging period	EGWWS WPI growth	All Industries WPI Growth	Premium
2003-2023 (20 year)	3.43%	3.03%	0.40%
2008-2023 (15 year)	3.07%	2.75%	0.32%
2013-2023 (10 year)	2.55%	2.30%	0.25%
2018-2023 (5 year)	2.00%	2.27%	-0.27%

Source: ABS, Synergies calculations

While there is evidence that the EGWWS premium over All Industries growth has narrowed over time, wages growth in the EGWWS sector exceeds that in the economy-wide (All Industries) series when viewed across three of the four averaging periods. This reflects the relatively high skills of EGWWS workers and their substitutability in relation to comparable work performed in other key sectors like mining and construction.

In particular, while the average wage premium between 2018 and 2023 has been -0.27%, having regard to the long term data going back to 2000, we consider that a premium of 0.40% is reasonable given the likely strength of WA and Australian labour market conditions in the AA6 regulatory period arising from strong growth in infrastructure activity across the energy, water and construction sectors. EGWWS workers have highly substitutable skillsets for workers in these sectors, which could be expected to result in a higher EGWWS premium than in recent history. Strong international demand for EGWWS workers arising from planned energy decarbonisation infrastructure construction will also likely influence Australian EGWWS labour market conditions.

In this regard, we note that in the December quarter 2022 and March quarter 2023, EGWWS WPI percentage growth from the corresponding quarter of the previous year was 3.6% and 3.9% respectively. This is the strongest year-on-year quarterly growth since June 2013.

Accordingly, we have adopted an EGWWS premium of 0.40% for use in the real labour cost escalation forecast, which we consider is most likely to reflect tight labour market conditions in ATCO's AA6 regulatory period.

#### 4.2.3 Step 3: Nominal labour cost escalation forecast

The nominal labour cost escalation forecast is calculated by summing the WA WPI estimate from Step 1 (3.50%) and the estimated EGWWS premium from Step 2 (0.40%).

The resulting nominal EGWWS labour cost escalation forecast is 3.90%.

#### 4.2.4 Step 4: CPI estimate for use in real labour cost escalation forecast

The CPI forecast that ERA uses in calculating its real labour cost escalation forecast is based on latest WA Treasury forecasts shown in Table 8.

**Table 8 CPI growth estimate based on ERA approach**

	2023-24 Budget year	2024-25 Outyear	2025-26 Outyear	2026/27 Outyear	Average
CPI growth	3.50%	2.75%	2.50%	2.50%	2.81%

Source: WA Treasury Economic Forecasts – Major Economic Aggregates

#### 4.2.5 Real labour cost escalation forecast

The ERA uses the following formula to calculate real labour cost escalation:<sup>29</sup>

$$\text{Real labour escalation growth rate \%} = \frac{1 + \text{Average growth in WPI}}{1 + \text{Average growth in CPI}} - 1 * 100$$

Substituting our WPI estimate (inclusive of EGWWS premium) and CPI estimate from the preceding sections gives the following estimate for the real labour escalation growth rate in Table 9.

<sup>29</sup> ERA (2021). Final decision on proposed revisions to the Dampier to Bunbury Natural Gas Pipeline access arrangement 2021 to 2025, 1 April, p.119.

**Table 9 Real labour cost escalation inputs and outcome**

Variable	% change
Annual average of WA All Industries WPI	3.50%
Plus premium of EGWWS WPI on All Industries WPI	0.4%
Equals nominal labour escalation forecast per year	3.54%
Less forecast CPI inflation per annum	2.81%
Equals labour escalation	1.06%

Source: Synergies using WA Treasury forecasts for WA All Industries and CPI inflation

Therefore, our forecast of the EGWWS real labour cost escalation growth rate for the AA6 regulatory period is **1.06%**.

### 4.3 Weighting of real labour cost escalator

In its most recent gas determinations, the AER has applied a real labour cost escalator benchmark weighting of 62% for labour and 38% for non-labour.<sup>30</sup>

The AER weightings were based on econometric analysis of gas distribution by both ACIL Allen and Economic Insights, and which has been submitted to the AER previously.<sup>31</sup> For these reasons, we consider the AER’s gas distribution network-specific weightings to be appropriate for ATCO.

### 4.4 Our recommendation

Table 10 presents our recommended real EGWWS labour cost escalation forecast for the AA6 regulatory period. These forecasts do not reflect the effect of the annual increases in the legislated superannuation rate up to 12% on 1 July 2025.

**Table 10 Real EGWWS labour escalation forecasts**

	CY2025	CY2026	CY2027	CY2028	CY2029
Real labour cost	1.06%	1.06%	1.06%	1.06%	1.06%

Source: Synergies

We consider that for the reasons outlined in this Section 4, this recommendation is consistent with Clause 74(2) of the National Gas Rules, which requires that it must be arrived at on a reasonable basis and must represent the best forecast or estimate possible in the circumstances.

<sup>30</sup> AER (2022), Draft Decision, Draft Decision Multinet Gas Networks Access Arrangement 2023 to 2028 (1 July 2023 to 30 June 2028), Attachment 6 Operating expenditure, (December) p 20. The approved real labour escalator weighting in this draft decision appears to have been retained for the AER’s Final Decision released in June 2023.

<sup>31</sup> Ibid, p 20.

We also recommend a real labour cost escalator weighting of 62.0% for ATCO's distribution network be applied in developing the opex and capex forecasts for the AA6 regulatory period.

## 5 Real materials escalation forecasts

The purpose of this section is to present our materials forecasts for ATCO's AA6 regulatory period.

### 5.1 ERA's preferred approach

ERA's preferred materials escalation approach is to assume materials prices move in line with CPI growth.

We understand that the materials cost escalators are likely to have a relatively small effect on ATCO's forecast expenditure as they reflect only forecast increases that are more than forecast CPI inflation. However, CPI inflation may not always be a good proxy for asset, equipment and materials cost inflation so ATCO could face a residual inflation risk exposure in the AA6 regulatory period if ERA's preferred forecasting approach is applied.

ATCO has requested Synergies to further investigate the possible use of materials cost escalators that differ from CPI for its AA6 opex forecasts for incorporation into the trend component of its base step trend forecasting methodology.

### 5.2 Issues to be considered with materials escalation

To be able to validly apply separate materials escalation to a cost base several things are required:

- (a) **A statistically valid estimate of the proportion of the cost base for relevant materials.** This will require an examination of opex composition as it will certainly have different proportions of materials and different materials-type profiles.
- (b) **Identifying available data on materials escalation.** The ABS publishes a wide set of Producer Price Indices (PPI) that are potentially relevant. Some commodities that are traded in futures contract markets may also be relevant.
- (c) **A valid basis for forecasting PPI indices,** recognising that forecasting and/or futures prices in relation to materials is not widespread. Selected commodity price forecasting and associated traded commodity futures prices are more common than for finished materials prices, where in our experience there is negligible future price information.

We will focus primarily on opex given ERA's use of materials escalation in its base step trend forecasting methodology.

### 5.2.1 Opex materials escalation

Our interpretation of recent ERA determinations, as well as the ATCO AA5 determination, is that materials escalation is used in the opex base step trend forecasting methodology (as part of the trend component) but not in developing capex forecasts. Consequently, materials used in ATCO's opex are likely to be more important from an escalation perspective.

**(a) A statistically valid estimation of the proportion of the opex base that is for various materials.**

ATCO's opex (excluding unaccounted for gas) has the components set out in Table 11 with our best understanding of the materials used and the proportion of opex categories that materials make up.

**Table 11 Opex materials and proportion of costs (not including unaccounted for gas)**

Opex category	Materials	Proportions
Network-related	Various	Minor to intermediate
Corporate	Office supplies, electricity, rent, insurance	Minor
Information technology	Electricity, office supplies, rent	Minor
Ancillary services	Various	Minor

As can be seen from the table, we assess the materials used for opex for most categories to represent a minor proportion of opex. This is because by nature opex is labour intensive. The category which is most likely to have any significant proportion of materials is the Network-related category, such as vehicle fuel and electricity and miscellaneous supplies such as lubricants, gasket materials, filters. However, the relatively large and diverse number of items creates challenges in determining a single representative escalator, or alternatively a composite weighted materials index of some form.

We expect ancillary service materials and proportions to be like the Network related category.

In contrast, we expect Corporate and IT materials are largely office supplies, electricity, insurance and rent, but only as a minor proportion of total opex.

**(b) Identifying available data on material escalation.**

There are PPI indices for retail electricity, office supplies (stationery) and vehicle fuel. We have not identified appropriate PPI indices for miscellaneous materials.

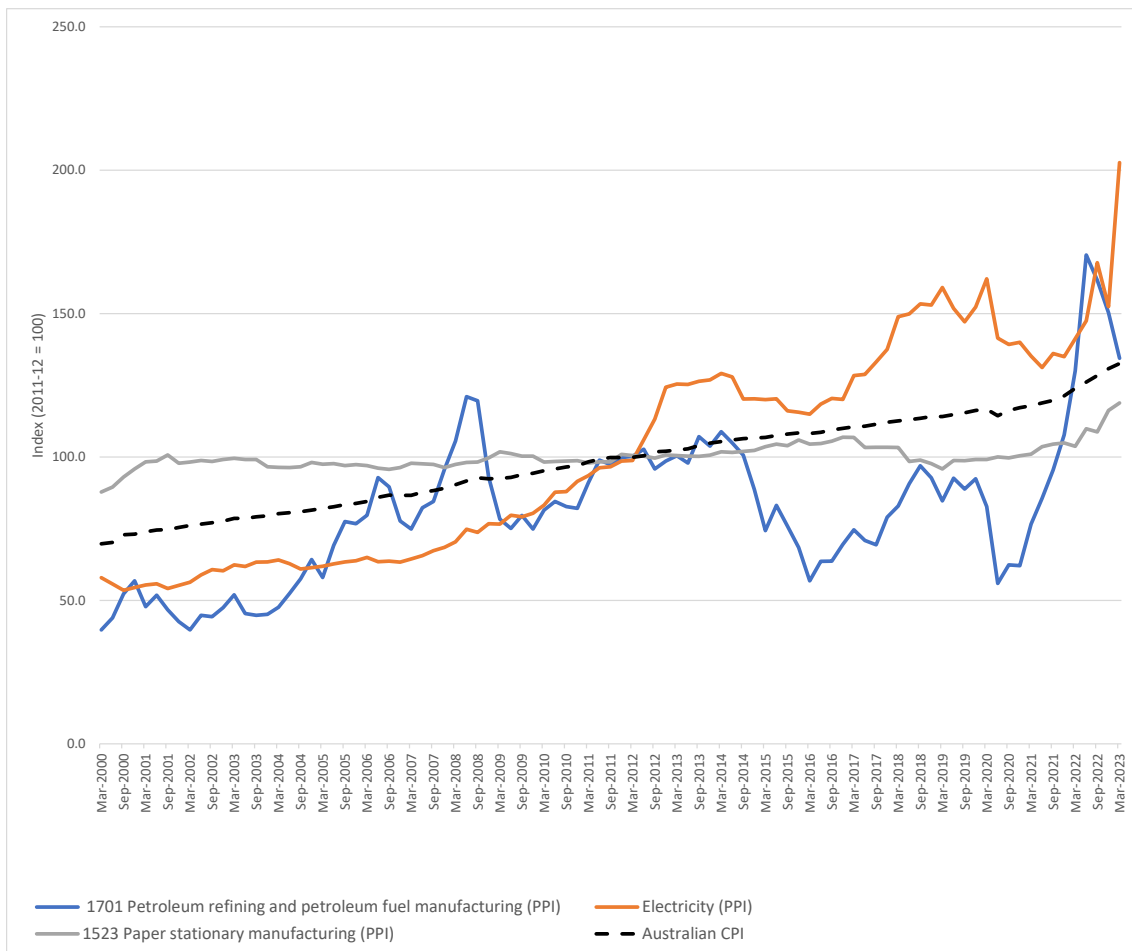
**(c) A valid basis for forecasting PPI indices**

Having established there are available and appropriate PPI indices, the next step is to determine a reliable forecasting methodology.

*Network-related costs*

Figure 5 shows historical movements in CPI and selected potentially relevant PPI indices to provide an indication of whether CPI escalation is a reasonable proxy for movements in the PPI indices,

**Figure 5 Index movements in CPI and selected PPI indices for opex**



The figure shows that there is no simple trend or average projection of the ABS data that is statistically valid for the fuel and electricity series. While the indices show vehicle fuel costs have increased sharply in the past two or three years, these have peaked and are falling. Electricity prices have been volatile and also increased sharply in the two past

two years, but this is likely not applicable to the West Coast as it is not affected by gas and coal prices in the same way as the National Electricity Market and is probably not representative of WA retail electricity price movements. Office supplies are not volatile with movements less than CPI until 2021, after which they have broadly followed CPI growth.

What is also evident from Figure 5 is that over the medium to long term, fuel and electricity prices move around much more unpredictably than CPI. It would therefore simply be incorrect to apply the apparent short or even medium term trends to them to determine the out-turn 5 years. Office supplies are much more predictable but can be expected to move at the same rate as CPI or less, and in this case, there is little benefit in seeking a materials escalator for them. The drivers of prices for fuel and electricity are supply (including supply chain issues) and demand. For fuel, this will primarily be at the global level. For electricity, it will be at the state level in the case of WA. Forecasting fuel and electricity prices is challenging given potential volatility in the underlying series. In this regard, there are no traded electricity future prices in the WA market. For diesel and gasoline, there are international traded futures markets, including in the US and Singapore. Futures prices for these products out to around 2026 have declined since the sharp peaks recorded in 2022, while remaining somewhat elevated compared to long term historical prices.

### *Corporate costs*

In terms of corporate and IT materials, the ABS CPI includes an insurance series which could potentially be used as a proxy for ATCO's insurance costs. The basis of any forecast developed for this series would need to be a long term trend growth in the sub-index compared to total CPI, assuming that any difference in long term trend growth in the two indices would persist into the future (or at least for the term of the AA6 regulatory period).

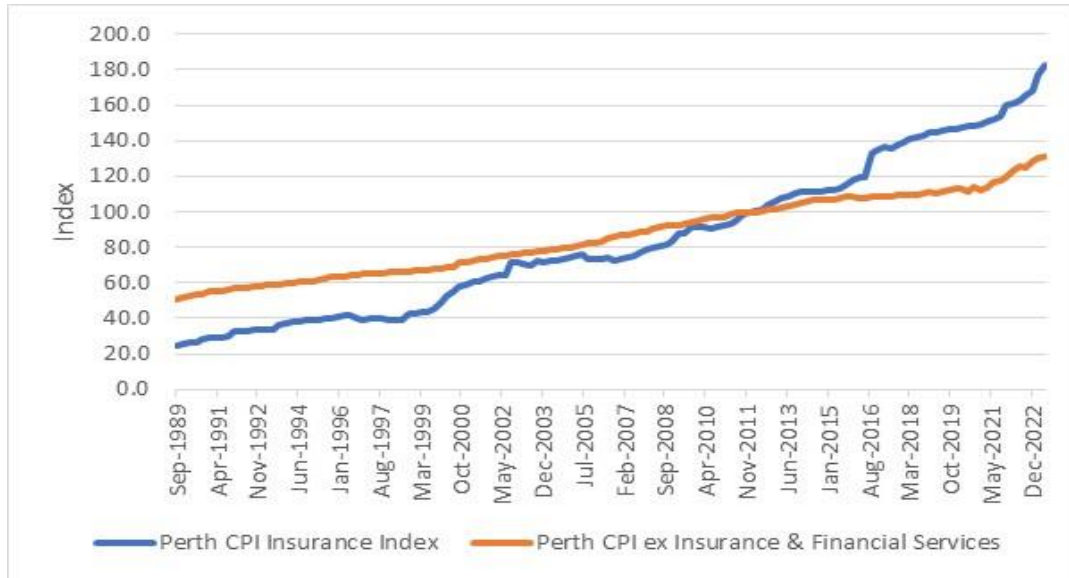
Recognising the challenges of finding appropriate materials escalators, a key alternative approach is ensuring opex items that are likely to escalate by much more than CPI growth should be removed from the base step trend opex forecast. Insurance appears to be a good example of this.

Figure 6 below shows the Perth CPI insurance index compared to Perth total CPI index (excluding insurance and financial services) since 1989. The compound quarterly growth rate of the insurance index was 1.5% between September 1989 and June 2023 compared to 0.7% compound quarterly growth for the CPI index excluding insurance and financial services. Further, compound quarterly growth in insurance costs has increased since 2021 at around 1.9% compared to 1.4% for the CPI. This longer term growth differential, which we consider is unlikely to close materially in the AA6 period given challenging



Australian and international insurance market conditions, supports insurance not forming part of the base step trend forecast and rather should be based on advice from an insurance broker/expert. There may be other atypical opex sub-categories that justify a separate ground-up forecast.

**Figure 6 Perth CPI Insurance Index compared to Perth CPI ex insurance and financial services**



Data source: ABS

### 5.3 Conclusion on opex material escalators

The development of economically and statistically meaningful forecasts of material escalators using indices other than CPI and that are relevant to ATCO's opex is challenging for the following reasons.

- (a) It may be possible to estimate robust proportions for each of the main types of opex, however, the proportion of costs made up by materials (including electricity) is likely to be quite small and would involve a reasonably large amount of up-front analytical and ongoing maintenance work with attached administrative cost. Any benefit from this additional work may not be worth the benefit gained.
- (b) It is possible to identify appropriate ABS PPI indices for some of the relevant inputs (fuel and electricity and office supplies) but developing valid forecasts for each of the inputs is challenging. The longest period for which a defensible forecast could potentially be developed for electricity and petrol/diesel is around 12 to 24 months based on publicly available analyst or government entity market forecasts. Anything beyond that would need to be underpinned by traded electricity and petrol/diesel futures prices that we understand are not available in the WEM so

price proxies from other markets would be required to varying degrees of reliability.

A fallback for ATCO would be ensuring that any material opex sub-categories that it is concerned may grow by more than CPI forecast growth in the AA6 period should be removed from the base step trend calculation and subject to a ground up cost calculation.

What this suggests is that while CPI may be a relatively poor proxy for many of the materials in principle, in the long run it is likely to be a reasonable option for forecasting materials cost movements, particularly in the absence of a gas network-specific materials index.

Given (i) the relatively small proportion of materials in ATCO's opex (ii) the limited availability of fit-for-purpose PPI and CPI sub-component escalators and (iii) the absence of any reliable 5 year forecasts for the PPI and CPI sub-component indices, we consider it is not feasible to develop materials cost escalator forecasts that would be reliable.

Consequently, our recommendation is for zero real growth for materials escalation in the AA6 regulatory period (ie. link forecast growth to forecast movements in CPI).

## 5.4 Our recommendation

Table 12 presents our recommended real materials cost escalation forecast for the AA6 regulatory period.

**Table 12 Real materials escalation forecasts**

	CY2025	CY2026	CY2027	CY2028	CY2029
Real materials cost	0%	0%	0%	0%	0%

Source: Synergies

We consider that for the reasons outlined in this Section 5, this recommendation is consistent with Clause 74(2) of the National Gas Rules, which requires that it must be arrived at on a reasonable basis and must represent the best forecast or estimate possible in the circumstances.

## 6 Opex productivity forecast

The purpose of this section is to present our opex productivity forecasts for ATCO's AA6 regulatory period.

### 6.1 ERA's Final Decision for AA5

ERA's Final Decision for ATCO's current (AA5) regulatory period approved a zero opex productivity factor to be used in ATCO's opex base step trend forecasting methodology.

ERA's main reasons for its final decision were that it was unlikely that ATCO would improve its opex productivity in the AA5 regulatory period due to:<sup>32</sup>

- most of ATCO's proposed capex was for network sustaining and network growth projects and structures and equipment, rather than strategic projects to enhance the productivity and efficiency of its operations or reduce ATCO's operating cost structure; and
- the forecast scale of ATCO's operations, represented by its forecast total new connections numbers and gas throughput would decrease over AA5.

In making its final decision, ERA noted that any future assessments of productivity change will be based on consideration of the expected circumstances during the period for which productivity changes are being assessed.<sup>33</sup>

### 6.2 AA6 opex productivity factor forecast

Recognising ERA's approach to determining an opex productivity assumption for the current (AA5) regulatory period, we have confirmed with ATCO that its proposed capex forecasts in the AA6 regulatory period are principally sustaining and network growth projects, which are unlikely to influence opex productivity in any material way. This is essentially the same capex profile that ATCO is implementing in the current regulatory period.

We have also confirmed with ATCO that its AA6 forecasts regarding the growth/scale drivers of connections numbers and gas throughput are as follows:

- declining gas throughput and
- slow growth in total new connections.

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<sup>32</sup> ERA (2019), Final decision on proposed revisions to the Mid-West and South-West Gas Distribution Systems access arrangement for 2020 to 2024, (November), pp 97-98.

<sup>33</sup> ERA (2019), p 147

We consider that these growth/scale forecasts, in aggregate, are weak and as such are unlikely to materially drive improvements in ATCO's opex productivity in the AA6 regulatory period.

In forming these views, we recognise that ATCO may make opex productivity improvements in the AA6 regulatory period. Its historical opex productivity performance demonstrates achievement of such improvements, which ultimately has been to the long-term benefit of gas consumers connected to the Mid-West and South-West distribution systems. However, the key point is that rather than incorporating a forecast of opex productivity improvement in the AA6 opex forecast given unsupportive forecast capex and growth/scale factors, ATCO's past performance suggests it will, to the extent possible, seek out opex productivity improvements. If achieved, these improvements would be reflected in ATCO's AA7 base year opex to the benefit of its gas consumers.

### **6.3 Our recommendation**

We recommend that a zero percentage opex productivity factor be applied in ATCO's opex base step trend forecast for the AA6 regulatory period.

We consider that for the reasons outlined in this Section 6, this recommendation is consistent with Clause 74(2) of the National Gas Rules, which requires that it must be arrived at on a reasonable basis and must represent the best forecast or estimate possible in the circumstances.