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Economic Regulation Authority
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Submitted via: www.erawa.com.au/consultation

DRAFT DETERMINATION - 2023 BRCP FOR THE 2025/26 CAPACITY YEAR

Alinta Energy appreciates the opportunity to provide feedback on the ERA's draft determination on the BRCP for the 2025/26 capacity year.

We make the following points for the ERA's consideration:

1. The exchange rate forecast appears too aggressive considering that the differences in Australia and USA's wage growth, monetary policy strategies and reactions to higher rate may maintain the current interest rate differential. PWC's labour cost forecast also appears inconsistent with a tightening differential. Additionally, given the current revenue inadequacy noted by the ERA, and the risk of a shortfall it is better to err with the more conservative estimates of financial institutions.

2. Steel and copper prices appear understated, noting recent events which have stabilised prices compared with PWC's forecasts for continued declines, and the contrast with S&P Global's consensus price forecasts.

3. Labour, construction, turbine, and transmission connection forecast costs may be understated, noting the significant amount of investment required in the SWIS to cover the planned retirements, supply chain issues, and reports of labour and infrastructure shortages and increasing prices.

These points are discussed in more detail below.

1. <u>The exchange rate forecast appears too aggressive</u>:

    - PWC is forecasting a relatively aggressive appreciation, citing the forecasts of some investment banks and the expectation that the differential between Australian interest rates will tighten. However, it does not examine the factors forecast to cause this tightening.

    - The AUD/USD rate has depreciated significantly since PWC's forecast as the RBA increased rates by a much smaller rate than was widely anticipated (0.25 percentage points), while the Federal Reserve continued to increase their rates by 0.75 percentage points.

    - Since PWC's forecasts, distinct differences in Australian and US monetary policy have

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emerged that increased the interest rate differential and indicate it could remain, keeping downward pressure on the AUD. For example:

a. **The RBA plans to link rates rises with wages, and signalled rates could stabilise if wages remain which are growing much slower than the US.** Immediately before the RBA increased rates at a much lower rate than the US in October and November, Philip Lowe signalled that the RBA's decision to slow rate rises will depend on wages remaining moderate compared with other countries like the US[1,2] where wages have increase by 6% compared with 3.1% in Australia[3] . He said there was an "important difference" between wage growth Australia and the US and noted that if this remains, inflation and interest rate rises could stabilise.

b. **ERA's labour cost forecast is inconsistent with a decreasing interest rate differential.** If ERA retains the draft determination forecast of labour costs to remain at ~3% change per annum, this suggests a wage differential would remain as well (based on wage trends in the US), and therefore an inflation and interest rate differential would too.

c. **The RBA has noted that wages in Australia would not increase as rapidly as those in the US** due to inertia in Australia's wage setting processes – e.g., enterprise agreements that are get renegotiated every two to three years, the annual review of award wages by the Fair Work Commission and public sector wages policies.[4] Australia's wage growth has since tracked much lower than the US, consistent with this theory.

d. **The RBA looks likely to continue moderate its rate increases compared to the US out of its greater concern for increasing households' mortgage stress.** RBA said a key reason it moderated its rate rises (relative to the US) was to avoid increasing mortgage stress on households. [5,6] However, this has not factored in the US Federal Reserve's calculus as it has maintained consistently higher increases. This is because most US households use 30-year fixed mortgages and are therefore not as exposed. Per the Federal Reserve Governor's latest speech, their board is more concerned with how the rate rises impact house prices, which have not fallen as dramatically as in Australia.[7]

- We note that the forecast appears to be among the more aggressive of those from major financial institutions and suggest that given indications that revenue will be insufficient to signal more investment despite the urgent need and forecast shortfall (and the reasons above) it would be better to err with more cautious portion of the most current forecasts.

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[1] *AFR*, *RBA rate rises tied to wages, says Lowe*, September 2022.

[2] *Philip Lowe, Inflation and the Monetary Policy Framework* "[…] wages growth has picked up, but not nearly to the same extent as in the United States. This is an important difference. […] aggregate growth in wages has not responded materially to the higher inflation and is not inconsistent with inflation returning to target over time. It is important that this remains the case and that we avoid the cycle of higher inflation leading to higher wages growth and then higher inflation – a cycle like that would end in higher interest rates and a sharper slowing in the economy."

[3] SMH, *Didn't get that pay rise? You might be better off without it*, 16 November 2022

[4] Philip Lowe, *The RBA and the Australian Economy*, December 2021

[5] The RBA's *Minutes of the Monetary Policy Meeting of the Reserve Bank Board* notes that the key reason for the lower November increase was that "the higher interest rates and high inflation were putting pressure on household budgets at a time when housing prices were also falling. The full effects of higher interest rates were yet to be felt in mortgage payments[…]"

[6] The SMH reported that the "RBA is increasingly aware of the financial pressure high inflation and increased interest rates are putting on households."

[7] Governor Christopher J. Waller, *the Economic Outlook and a Word of Caution on Inflation*, November 2016.

2. Steel and copper price forecasts appear understated:

   - PWC appears to have made its forecast when the copper price was near a 20-year-low. According to S&P Global, recent events since this forecast, including China's October National Congress re-affirming its commitment to electrifying transport, and the focus on EV sector growth during the LME week, have bolstered copper demand forecasts, helped the price recover, and resulted in consensus forecasts that copper prices will be higher than current levels in 2025.[8] This contrasts with PWC's forecast that copper prices will decrease by -8.95% in 2023, -11.90% in 2024, and -4.41% in 2025.

   - S&P Global also predicts steel prices will remain stable around current levels following the dramatic decline earlier this year[9], whereas PWC forecasts dramatic declines: -28.08% in 2023, -16.31% in 2024 and -11.39% in 2025.

3. Labour, construction, turbine, and transmission connection forecast costs may be understated, noting the significant amount of investment required in the SWIS to cover the planned retirements, supply chain issues, and reports of labour infrastructure shortages and increasing prices.

   - The SWIS requires significant investment in the short to medium terms and will be competing for resources with NEM and the world as the energy transition accelerates. Even with the WEM ESOO demand assumptions which are much more conservative relative to the ISP,[10] the SWIS faces a significant challenge to deliver the investment required to maintain reliability. We estimate that replacing Synergy's planned retirements, while meeting the forecast shortfall in capacity and the government's 80% emissions reduction target may require ~$13bn of investment in generation and storage before 2030. Publicly reported plans to potentially substitute from thermal generation or electrify, including from Boddington Gold Mine, South 32, and Alcoa could significantly increase this requirement and bring the WEM closer to the NEM's ISP demand forecast which is expected to double by 2050 to meet net zero. We suggest that this increase in local demand for electricity infrastructure will add to pressure on labour, transmission, and generator construction costs.

   - Western Power's revised AA5 proposal cites "higher inflation", "delivery challenges presented by the current world climate", "competition for local resources, and "global supply chain disruptions" in updating its costs and productivity factor. However, these factors are not referenced in Western Power's *Total Transmission Cost Estimate for the BRCP* and don't appear to be impacting the estimate with escalation only forecast at 1.92%.

   - Public reports of transformer shortages, increasing lead times from three months to 12-18[11], and increases of transformer costs of up to "two to three times"[12] also contrast starkly with this low estimate.

   - GHD used the copper and steel escalation factors to forecast that the cost of a candidate OCGT, the Siemens SGT5-2000E, would decrease ~10% by 2025/26. However, this seems unlikely, noting that:

[8] S&P Global, *S&P Global Commodity Insights*, November 2022
[9] S&P Global, *Steel Price Forecast and Steel Market Outlook*, November 2022
[10] Compared with AEMO's ISP which forecasts demand doubling by 2050 in every scenario to meet net zero.
[11] American Public Power Association, *We must keep expressing urgency about the transformer crisis* October 2022
[12] American Public Power Association, *Shortage Changed: How Utilities Are Adapting to Supply Chain Issues* February 2022

a. Gas turbine OEMs are expecting increasing turbine prices over the next 5 years;[13] and

b. Siemens Energy AG have reported higher costs due supply-chain problems and indicated they will continue.[14] In November, Maria Ferraro, CFO of Siemens Energy said "High inflation, material costs and supply chain issues will not go away in this coming year."[15]

- The Draft Determination forecasts construction labour costs to increasing by 2.49% in 2022/23 and then rising by 2.74% through to 2025/26 while maintenance labour trnes marginally higher. We note that both are below the annual 3.1% change reported by the ABS,[16] and that we would expect these labour costs to increase more than the national average, given the increasing demand for these skill sets in particular.

If you would like to discuss further, please contact me at oscar.carlberg@alintaenergy.com.au or on 0409 501 570.

Yours sincerely

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[13] Gas Turbine World, *2022-2031 Gas Turbine Market Forecast* April 2022.
[14] *Independent.ie* *Siemens swings to loss after write-downs and supply chain drag* August 2022
[15] Siemens press release November 2022
[16] ABS, Wage Price Index, Australia