# Construction Brief

23 October 2017

## Another Energy Policy

***Insight****:* In this edition we look at the efficiency and effectiveness of the Energy Policy announced by the Prime Minster last week.

***Update****:* The Prime Minister, Malcolm Turnbull, released an outline of a new carbon and energy plan: 'Powering Forward: A better energy future for Australia.'

The limited detail on this plan makes it difficult to analyse and key details are likely to be made available in coming months. The main features are:

1. The National Energy Guarantee **(the NEG)** is a reliability standard set by the Australian Energy Market Commission and the Australian Energy Market Operator (AEMO) is a reliability standard.
2. The **Emissions Guarantee** will be determined by the Commonwealth Government and sets a maximum threshold on emissions from generation.

In essence, the Plan will force electricity retailers to contract generators to provide a guaranteed minimum reliability standard and maximum carbon emission outcome.

The costs of these goals will be imposed on generators who will pass the costs through as embedded costs within contracts to retailers and ultimately to consumers. The Government correctly claims that this plan is technology neutral and provides clear signals to generators on when and where to invest.

The plan is a significant move away from the policy principles that have applied to its predecessors. In 2005 the Howard Government established the principles for subsequent policies: They need to be market based and economy wide.

This policy is specific to electricity and the costs will be obscured from the public. This does not prohibit the policy from being efficient and effective at achieving their objectives.

**The NEG** aims to avoid blackouts caused by insufficient generation. Forcing retailers to buy generation is an effective way of achieving this outcome.

The risk of systemic black-outs this summer have been cautioned by the industry and by AEMO. Recent events in South Australia have focused the Governments attention.

The Plan will assist in providing certainty to investors in electricity generation and in avoiding blackouts in the summer months over the next couple of years.

The downward impact on prices, even according to the Governments own modelling, will be moderate at best.

The amount of generation that retailers will be required to purchase will be based on the same forecasts that have resulted in over-investment in poles and wires and therefore responsible for the significant price increases up to 2015.

This raises a concern that similar over-investment in generation could occur through the NEG.

The tool which the Government will use to determine the appropriate level of investment in new generation will be the AEMO's forecasting tools. Over the past decade these forecasts have been wildly inaccurate and have consistently over-estimated demand.

The efficiency and effectiveness of the **Environmental Guarantee** is even less apparent.

Unlike the NEG, which can be implemented through changes to the Market Rules, the Environmental Guarantee will most likely require legislative change.

The Environmental Guarantee could be effective at abating emissions through commercial contracts. As a consequence however, without an open and transparent market the costs of abatement will be obscured to policy makers.

Without a clear market signal for the cost of abatement it is difficult for policy makers to set abatement goals.

The Prime Minister has not clarified if international abatement units can be used to achieve the guarantee. If access to these units is permitted, then there is a wide and deep abatement market available to achieve significant domestic offsets, at a low price.

With both federal and state Parliaments likely to be involved in the debate on this policy, it may be sometime before the detail is known.

### Domestic Inflation Outlook

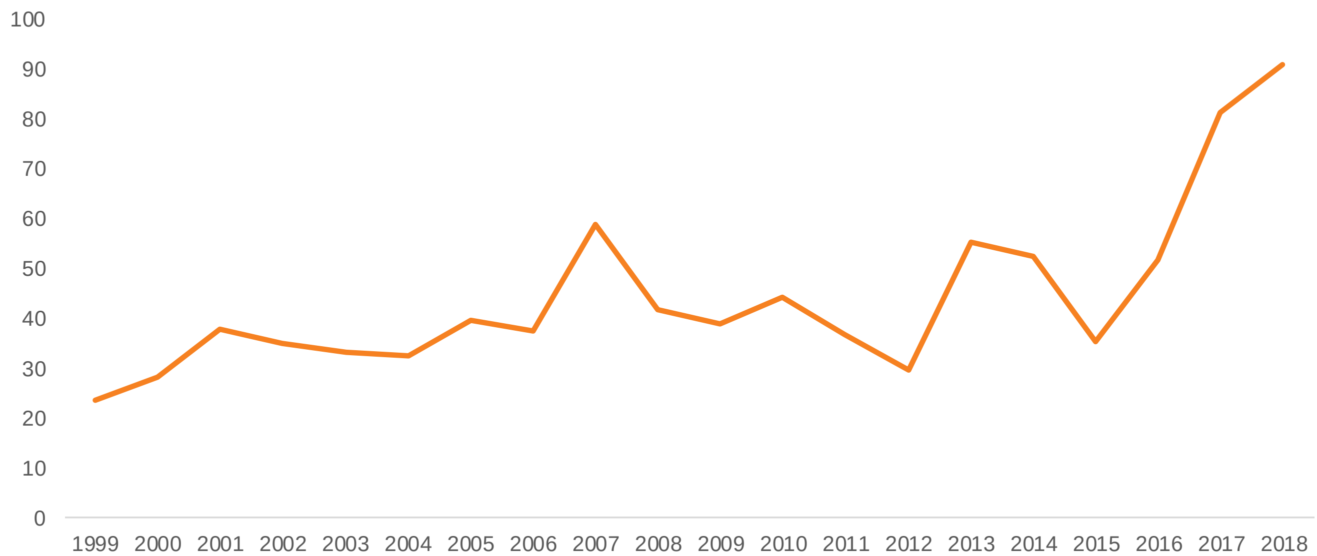
***Insight****:* The ABS will this week (Wednesday) release CPI figures for the September 2017 quarter. Two themes to be cognisant of in and around this release are the international context and domestic energy prices.

Across the globe, many advanced economies have already received their updates to CPI for the September quarter. In the US, underlying annual inflation was below the 2 per cent target (headline annual inflation outstripped two per cent, largely due to a cyclone Harvey-related increase in fuel prices). Across the Atlantic, however, the situation is somewhat mixed. In the Eurozone, economic growth continues to gather momentum but the labour market is yet to catch up, leaving general inflation below the ECB's near-2 per cent target – annual inflation in September came in at 1.5 per cent. The UK is something of an outlier, however, with Brexit a key factor in this situation. Annual inflation in September came in at 3 per cent – outstripping their central bank's 2 per cent target. In general, expectations are that inflation in these major economies is set to gather pace as their economic growth recovers, with the UK leading the way. However, the situation in the US could prove instructive, not just for these northern hemisphere economies, but also for us here in Australia. To paraphrase Janet Yellen, US policy makers have been surprised [perhaps bemused] by enduring low inflation underscored by low wages growth despite accelerating economic growth and a labour market arguably at full employment.

Turning the focus domestically, the effect of sharply rising household energy costs (– except for in WA, with many households having experienced up to 20 per cent increases in their energy bills) will put pressure on inflation over the next four quarters before the price increase 'washes through' the CPI readings. Without growth in wages, these rising energy costs (hard near impossible to avoid) are likely to simply dampen household expenditure in non-essential areas. Already retail spending has slumped since the start of the new financial year, suggesting that this is the area where households are cutting back. Ultimately this will serve to keep a lid on inflation (at least this retail element of consumer prices) – in the face of weak demand, retailers won't have much scope for raising their prices.

These two themes surrounding Australia's inflation situation both point to a risk that domestic inflation (and by extension interest rates) will remain lower for longer than expected.

## WHOLESALE ELECTRICITY PRICE (NSW $/MWHR)




Source: AEMO

### The fortnight ahead – key dates and releases

**Tuesday 24 October**

HIA-CoreLogic Residential Land Report, June Qtr 2017 11am

**Wednesday 25 October**

ABS Consumer Price Index, Australia, September 2017, 11.30am

**Thursday 26 October**

HIA Trades Report September Qtr 2017, 11.00am

**Tuesday 31 October**

HIA New Home Sales Report 11.00am

**Thursday 2 November**

ABS Building Approvals, September 2017 11.30am

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