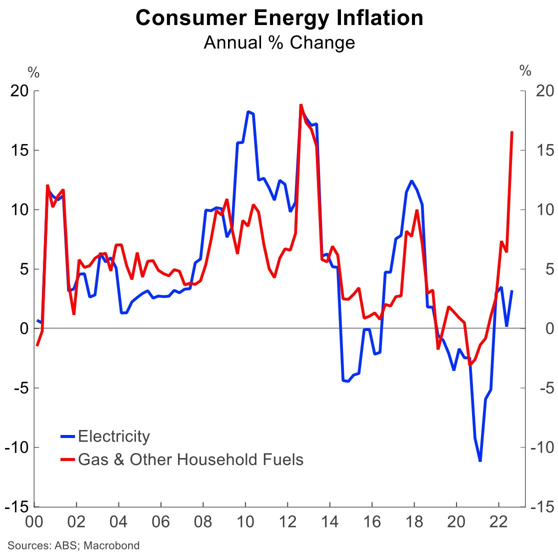
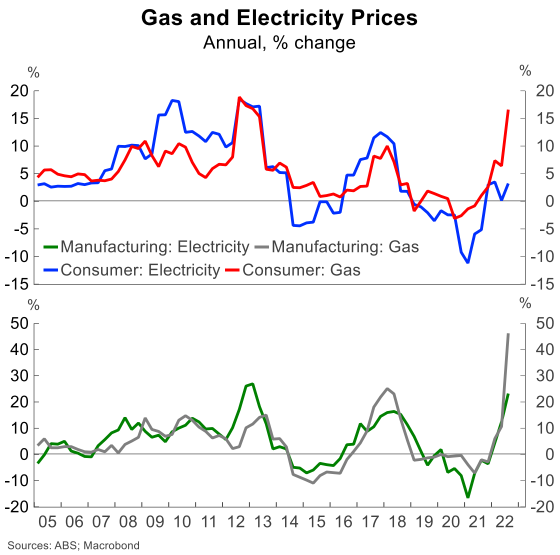
Friday, 16 December 2022

Energy Policy Analysis

Impacts of the New Energy Policy on Inflation

- **The Energy Price Relief Plan passed Parliament yesterday after out-of-pocket energy prices were forecast to escalate at an alarming rate in the October Budget. The new Plan aims to reduce the out-of-pocket energy costs faced by households and businesses. It does this by capping gas and coal prices and by crediting the energy bills of certain households and small businesses.**
- **The key question is what these policies will mean for inflation.**
- **Firstly, the measures will reduce the cost of energy across the economy and, all else equal, will put downward pressure on the consumer price index (CPI) in the short-term.**
- **Secondly, cheaper energy prices will mean there is more cash for *all* households and businesses to spend. This will add to demand in the economy at a time when the Reserve Bank (RBA) is trying to slow demand to bring it into balance with supply.**
- **On balance, based on what the Government has publicly released, we anticipate there are downside risks for inflation in the short run. The Government expects 0.5 percentage points to be shaved off inflation over 2023-25. But given demand will be higher than otherwise, over time there could be some upward pressure on inflation via second-round effects.**
- **Finally, it is unclear whether the Plan will increase energy prices through disincentivising investment. Producers should remain profitable under the price caps, however, there is a risk producers will favour more profitable projects overseas. This could reduce domestic supply meaning higher prices.**
- **The Plan is unlikely to materially impact the RBA's current course in the short term. However, there are uncertainties. One of these uncertainties is the Government's agreement to announce a "significant package" of measures for the electrification of premises in next year's Budget. Further details are required to ascertain if this will unlock more demand.**





Policy Summary

Out-of-pocket energy prices were forecast to increase at an alarming rate in the October Budget – by 20% in 2022 and 30% in 2023. The Government announced that it was looking at several ways to reduce these out-of-pocket prices, including through taxing producers, imposing regulation and direct handouts.

National Cabinet agreed to a hybrid approach on 9 December. This included placing a cap on domestic wholesale gas and thermal coal prices, which will benefit all households and businesses. In addition, the Government will provide targeted support for certain low- and middle-income households and small businesses. This targeted support will reduce the size of their energy bill.

The key question is what these policies will mean for inflation in Australia. Under the Government's hybrid approach, inflation will be impacted in several ways. We have considered three of these impacts:

1. The direct impact of lower energy prices on the consumer price index (CPI);
2. The indirect impact of household and small business energy 'savings'; and
3. The long-term impact on energy investment and prices.

1. Direct Impact of Lower Energy Prices on the CPI

Energy prices are an important component of household consumption, and therefore, the CPI. Electricity accounts for about 2.2% of the CPI basket. Around 60% of electricity generation comes from coal-fired power and around 15% is sourced from natural gas. Additionally, 'gas and other household fuels' make up just under 1% of the CPI basket. Energy is a key input for businesses, which flows into the price households pay for other goods and services.

The price households and businesses pay for electricity and gas is, therefore, an important driver of inflation. The Government estimates that the first-round effects of its policy would be to lower

CPI by 0.5 percentage points in 2023-25 because of the caps, and by a further 0.25 of a point due to rebates or credits for certain households and small businesses.

Price caps

Larger businesses can source gas and electricity directly from the wholesale market. The cap on wholesale coal and gas will, therefore, directly flow through to their energy costs on new contracts.

For households and most small-to-medium businesses, the transmission is not as straightforward. They purchase energy from retailers, at the retail price. Retailers are the middleperson; they purchase electricity and gas at the wholesale price and sell it to households and businesses at the retail price. The difference is the margin the retailer takes.

Given the Government's price caps are targeted at wholesale prices, there is a risk that retailers bank the windfall through higher margins and do not pass the benefits on to consumers. However, it is likely the Australian Competition and Consumer Commission (ACCC) will be called in to make sure that lower wholesale prices are passed onto the end users, being households and businesses.

We, therefore, expect energy prices for households and businesses to be lower than they otherwise would have been without the price caps. However, given the forecast rise in gas and electricity prices, this will only manifest in smaller increases in prices, rather than a reduction.

Rebates

The $3 billion of government support will directly reduce the cost of gas and electricity for certain households and small businesses over and above the impact of the price caps. The support will be provided to low- and middle-income households and small businesses who do not have wholesale market contracts. It will likely be applied against energy bills in the form of a rebate or discount. This means that cash will be paid to energy retailers rather than to households and businesses. This will directly reduce the cost of electricity and gas for those included in the subsidy. Details of the rate of the subsidy and how it may be applied are yet to be announced. The Government has committed to provide final details in March 2023.

Together, these measures will reduce the cost of energy for households and businesses across the economy and all else equal, will put downward pressure on the CPI in the short term. However, this does not address the problem of inflation, it merely shifts the burden of higher prices on to the government. As the CPI only measures the price burden worn by consumers, the policies will artificially lower the CPI. However, broader measures of inflation, including the domestic demand deflator, are unlikely to experience the same downward pressure from the announced policies.

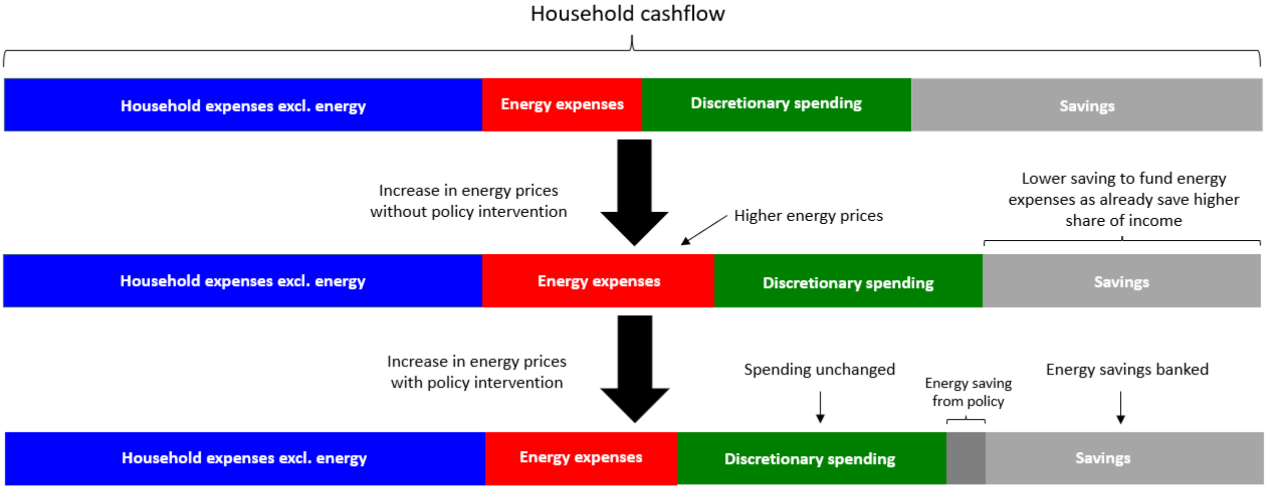
2. Household and Small Business Energy 'Savings' to Boost Demand

While households and businesses will not receive any cash from the Government as part of the policies announced, they will have lower energy bills than would have otherwise been the case. The benefit for households and businesses will, therefore, come in the way of savings, which may free up cash to be spent elsewhere in the economy.

These savings will be masked by the fact that energy prices will still be rising, just not as fast. It means the propensity to spend these savings will likely be lower. But in saying that, the total value of the stimulus is substantial and should not be ignored. Any fiscal stimulus in this form is inflationary because it adds to demand. This is especially the case when the economy is already pushing up against capacity constraints and the labour market is its tightest in a generation.

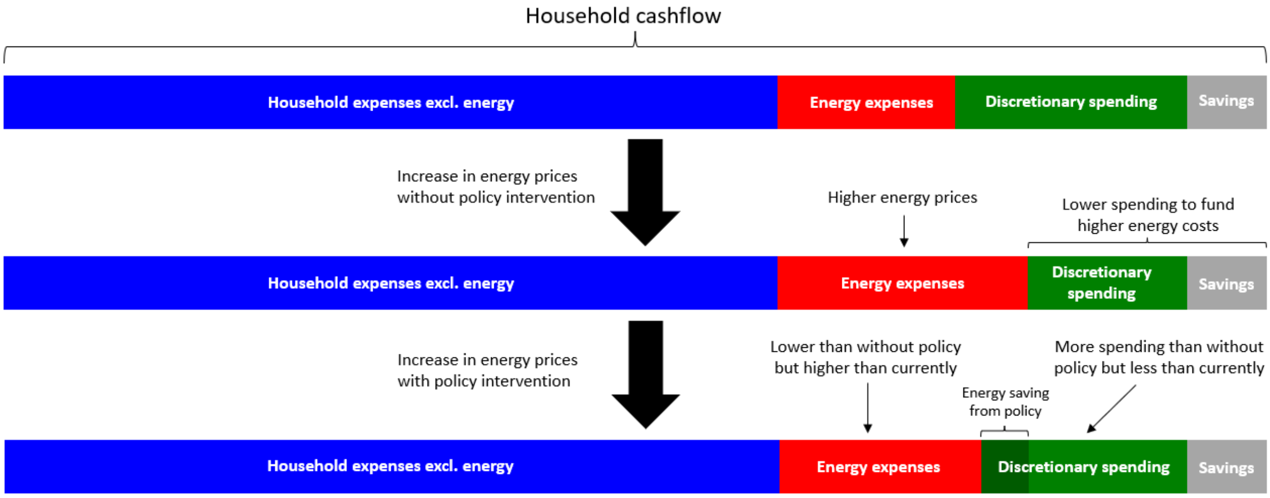
The price-cap element of the Government's energy policy is not a targeted measure. Instead, it will cover everyone in the economy as prices will be influenced at the top of the value chain. This means that the savings from lower energy bills will be shared economy wide. Wealthy households and businesses are more likely to bank the savings. This is because rising energy prices are unlikely to change their spending behaviour even if the Government did not intervene.

Example 1 – Households likely to save energy savings



However, many households and businesses would have had to pull-back on spending to afford higher energy prices had the Government not intervened. These households and businesses are more likely to spend the saving from lower prices to try and maintain their current levels of consumption. If this share is large enough, the boost to demand compared to without the policies could be very substantial and add to inflationary pressures.

Example 2 – Households likely to spend energy savings



This is more pronounced when considering the 'rebate' element of the policy. The saving from this rebate will be funnelled directly towards those who are most vulnerable to higher prices and who would have almost certainly had to cut back on spending to pay their energy bills. We know at least $3 billion will flow to these households through the rebates. This cohort is, therefore, extremely likely to spend the windfall from both the rebate and price-cap elements of the policy, meaning demand in the economy will be stronger than otherwise.

The Government's policy has offsetting impacts on inflation. On the one hand, cheaper energy prices put downward pressure on the CPI. However, cheaper energy prices mean there is more cash for households and businesses to spend, adding to demand and putting upward pressure on the CPI.

On balance, based on what the Government has publicly released, we think there could be downside risk for inflation in the short run. However, given demand will be higher than otherwise, over time there could be upward pressure on inflation. This could mean that inflation remains higher for longer.

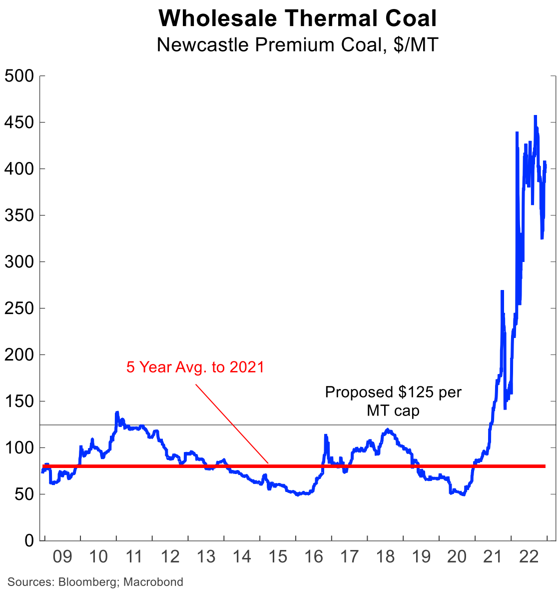
3. Long-term Impact on Investment and Prices

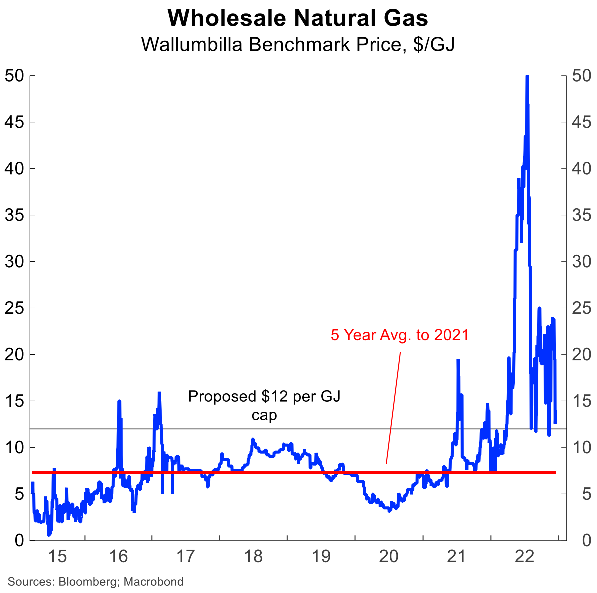
Producers and some analysts are of the view that the Government's policy may also add to inflation in the long-term - they claim that there will be more profitable projects overseas so they will be more likely to shift investments. Less domestic supply could mean higher domestic prices.

There are a few items to consider here.

Firstly, whether the price caps and regulation will inhibit investment. Industry participants, especially in the gas market where more details have been announced, have staunchly opposed the regulations on the basis that they will reduce investment. They have raised concerns about the new code of conduct, suggesting the requirement for a "reasonable price" may cap prices in the long term.

The price caps for both coal and gas have been set at a level that allows for 'reasonable profits'. In other words, the price cap has been set above the cost of production. In the 5 years leading up to 2021, before the recent spike in commodity prices, the wholesale price of coal averaged $80 per tonne, while the wholesale gas price averaged $7 per gigajoule. Both prices are well below the proposed price caps. Given the price caps are profitable and well-above the prices fetched before the recent spike, there is no reason to think that investment in coal and gas supply will be altered by the cap.





However, producers claim that they will shift their investments overseas where they can charge the global market price, which are well above the cap (particularly for coal). If this occurs, they suggest local supply will not keep up with demand and prices will spike.

The second point to consider is the green transition, which means gas and coal will become less important to our energy mix. If the price caps do reduce investment in new supply, this would be consistent with the transition to more sustainable energy sources. The key question is whether the renewable transition can progress rapidly enough to reduce demand for fossil fuel before a shortfall in coal and gas supply emerges from lower investment. There are risks that this may not occur and the supply of transitional sources of energy (including gas) is lower than demand. Indeed, some analysts flag the Government's Plan could significantly slow down the transition by removing the impetus to invest in renewable sources of energy, increasing the risk of a shortfall in transitional sources of energy.

Overall, it is unclear whether the Government's Plan will place upwards pressure on energy prices in the longer term through disincentivising investment. Ultimately, it will depend where the Government lands on the longer-term aspects of regulation, including the final makeup of the Code of Conduct for the gas market.

Conclusion

The Government's energy policy will impose two competing forces on inflation. Lower energy prices will directly lower the CPI, while at the same time adding to demand through savings. On balance we think there could be downside risk for inflation in the short run. However, given demand will be higher than otherwise, overtime there could be upward pressure on inflation.

Over the long-term, it is unclear whether the Government's Plan will place upwards pressure on energy prices through disincentivising investment. Ultimately, it will depend where the Government lands as it continues to consult on the longer-term aspects of regulation.

Turning to the Reserve Bank (RBA) and what the policy may mean for interest rates – it is unlikely to materially impact the RBA's current course. The RBA has recently honed its focus on domestic drivers of inflation, such as the tight labour market, wages growth and inflation expectations. The Government' Plan is unlikely to materially change the future evolution of these key variables.

However, there are uncertainties that we need to be cognisant of. One of these uncertainties is the Government's agreement to announce a "significant package" of measures for the electrification of premises in next year's Budget. Further details are required to ascertain whether this will unlock more demand and lead to higher inflation.

Jameson Coombs, Economist
Ph: +61 401 102 789

Pat Bustamante, Senior Economist
Ph: +61 468 571 786

Contact Listing

Chief Economist
Besa Deda
dedab@stgeorge.com.au
(02) 8254 3251

Senior Economist
Jarek Kowcza
jarek.kowcza@stgeorge.com.au
0481 476 436

Senior Economist
Pat Bustamante
pat.bustamante@stgeorge.com.au
0468 571 786

Economist
Jameson Coombs
jameson.cooombs@stgeorge.com.au
0401 102 789