

Real Price Effects

Prepared for the Utility Regulator

1 August 2012

Executive Summary

1. Forecast

The Utility Regulator has commissioned First Economics to produce a forecast of electricity industry real price effects (RPEs) for the period 2012/13 to 2016/17.

As in previous studies we have carried out, we have used the latest HM Treasury and Bank of England projections of GDP growth to anchor our forecast. The HM Treasury projections are now produced by the independent Office of Budget Responsibility (OBR) and were last updated in March 2012. The Bank of England forecasts come from the May 2012 Inflation Report. In both cases the outlook is one of subdued economic growth throughout 2012 before a recovery in the first half of 2013 and above-trend growth from late 2013 to 2015 or 2016.

Our forecast of nominal wage inflation for general labour is taken directly from the OBR projections. For other input types, we extrapolate from historical data and typically allow a gradual return back to the rates of nominal input price inflation that the electricity industry saw between 2003 and 2007.

Our nominal price inflation forecasts are set out in table 1.

Table 1: Input price inflation forecasts (%)

	2012/13	2013/14	2014/15	2015/16	2016/17
Labour – general	2.4	3.5	4.4	4.5	4.6
Labour – specialist	3.65	4.75	5.65	5.75	5.85
Materials – general/civils	2.0	3.5	4.5	4.5	4.5
Materials – electrical	2.0	4.0	5.0	5.0	5.0
Plant and equipment	2.0	3.0	4.0	4.0	4.0
IT	0.75	0.75	0.75	0.75	0.75
Property rentals	2.4	3.5	4.4	4.5	4.6

Our forecast of RPI-measured inflation is taken directly from the March 2012 OBR projections. Annual rates of inflation are set out in table 2.

Table 2: Inflation forecasts (%)

	2012/13	2013/14	2014/15	2015/16	2016/17
RPI-measured inflation	2.9%	2.2%	2.9%	3.8%	4.0%

Combining the projections in tables 1 and 2 gives the forecasts of RPEs set out in table 3 overleaf.

Table 3: First Economics' RPE estimates (%)

	2012/13	2013/14	2014/15	2015/16	2016/17
Labour – general	(0.5)	1.3	1.5	0.7	0.6
Labour – specialist	0.75	2.55	2.75	1.95	1.85
Materials – general/civils	(0.9)	1.3	1.6	0.7	0.5
Materials – electrical	(0.9)	1.8	2.1	1.2	1.0
Plant and equipment	(0.9)	0.8	1.1	0.2	0.0
IT	(2.15)	(1.45)	(2.15)	(3.05)	(3.25)
Property rentals	(0.5)	1.3	1.5	0.7	0.6

2. Backcast

The Utility Regulator also asked First Economics to produce a 'backcast' of RPEs between 2009/10 and 2011/12. We understand that these figures will be used for the purposes of rolling forward NIE's actual 2009/10 expenditure into starting allowances for the RP5 control period.

Our backcast is based on the out-turn change in published price indices. The chosen indices are:

- general wages – ONS, average weekly earnings (including bonuses) index;
- specialist wages – BEAMA, electrical engineering labour cost index;
- general materials – BCIS, resource cost of infrastructure materials cost index;
- specialist materials – BEAMA, basic electrical materials index;
- plant and equipment – BCIS, plant and road vehicles cost index;
- IT – ONS, SPPI computer services cost index; and
- rent – ONS, SPPI property rental cost index.

The nominal annual rates of change in the above indices in 2010/11 and 2011/12 are set out in the table below.

Table 4: Input price inflation estimates (%)

	2010/11	2011/12
Labour – general	1.6	2.0
Labour – specialist	3.4	1.4
Materials – general/civils	6.5	8.3
Materials – electrical	11.7	10.7
Plant and equipment	1.8	1.7
IT	1.3	0.6
Property rentals	0.2	0.0

The equivalent real price effects, against out-turn RPI-measured inflation of 5.0% in 2010/11 and 4.8% in 2011/12, are given in table 5 overleaf.

Table 5: RPE Estimates (%)

	2010/11	2011/12
Labour – general	(3.4)	(2.8)
Labour – specialist	(1.6)	(3.4)
Materials – general/civils	1.5	2.5
Materials – electrical	6.7	5.9
Plant and equipment	(3.2)	(3.1)
IT	(3.7)	(4.2)
Property rentals	(4.8)	(4.8)