Keeping us up at night

The big issues facing business leaders in 2018

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KPMG.com.au
Our daily news cycle features no shortage of voices confidently espousing the issues they believe to be of primary concern to Australian business.

Yet while we know the loudest voices are not necessarily the correct ones, it can nevertheless be challenging to identify a genuine signal through all the noise in the public sphere.

That is why at KPMG we are so pleased to be able to take our strong relationships with Australia’s top business leaders and combine them with the knowledge and skills of our new market research practice, KPMG Acuity Research and Insights.

The result is what we believe to be a clear and engaging insight into the real priority concerns of Australian business leaders as we head into the New Year.

Personally, what we found most immediately striking about the results of the 2018 outlook survey is the sheer consistency. Our survey covered a wide breadth of KPMG’s C-level clients, from small to medium enterprises, right through to some of Australia’s largest corporations. What it found is a group of Australian leaders very settled about their main concern.

No matter which way you slice the data the same issue dominates: digital and innovation. In this way, 2018 looms as a year of known unknowns. The nation’s leaders understand that disruption looms around every corner. They are now clear about what they need in order to respond and seize opportunity: a culture of innovation, especially in the digital space.

Today, there is no delusion among Australian leadership about the kind of global economic environment we inhabit. There is near universal awareness that the world has become, and will continue to become, a more complicated and unpredictable place.

While no one can confidently predict the exact disruptions that lie ahead, the organisations that get their innovation culture right will be the ones that can harness change to their benefit.

We are excited to glean these insights, and excited further at the prospect of using them to help your organisation grow and succeed in 2018.
Introduction

KPMG is fortunate to enjoy close relationships with many of Australia’s most influential business leaders. The views of any one of these leaders are of value. Combine them, however, and you get something of real importance.

This year we have obtained detailed qualitative data from almost 200 business leaders across the country. These C-level executives range across the nation’s major industries and sectors, from large corporations through to small and medium enterprises.

Speaking to these leaders provides unique insights into the strategic issues they are focused on and the key challenges they believe they face as they look to the year ahead.

Survey participants were asked to identify their key issues of concern and to offer their perspectives on why, for them, these issues rose above the pack.

Through this process we have been able to rank a top 10 of the most significant issues facing Australia’s leaders in 2018. This report contains an overview of each of these issues combined with some of the latest analysis and forecasts from KPMG’s experts in each field.

In addition, we have included longer analysis for the three leading areas of concern identified: digital and innovation, cost competitiveness, and energy. These pieces take a deeper dive into the main issues exercising Australian business leaders and offer insight into what is needed – and what is actually likely to happen over the next year.

How can businesses take practical steps toward a culture of innovation in 2018? How far behind is Australia really in terms of cost competitiveness and what can be done to fix it? What has driven our energy crisis to date and is there any prospect of relief in the year ahead?

We hope you enjoy delving into our answers and our analysis.

Beyond the Top 10

Other areas of importance which did not make the top 10 include:

- Climate change
- Education
- Tax reform
- Social cohesion
- Affordable housing
- Defence and security
- Indigenous business.
The TOP 10 most significant issues facing Australia’s leaders in 2018

1. Digital and Innovation
2. Cost competitiveness
3. Energy
4. Regulation
5. Government efficiencies
6. Public trust
7. Infrastructure and liveable cities
8. Fiscal sustainability
9. Big Data
10. Health

Click on the issues below to read our insights
Digital and Innovation

As we look toward 2018 we see the disruptive pressure on Australian business has increased. The American giant Amazon has entered the Australian market. The Tesla battery array in South Australia has gone live. And sometime next year it is likely that Facebook will allow its 15 million active Australian users to use its Facebook Messenger service for payments.

So it is perhaps not surprising to see ‘Digital and Innovation’ ranked as the clear number one priority issue for resolution in 2018. The rapidly evolving Australian landscape shows what is at stake when Australian businesses indicate they need to get their digital and innovation houses in order. Yet whilst ‘digital’ has certainly gone mainstream in terms of the executive agenda, innovation is an area where we continue to lag as a nation.

There are some positive signs, with several of our largest companies setting up venture arms and innovation labs. Some have even invested in training for new ways of working, such as Agile methodologies or Design Thinking. To make these efforts stick, however, concerted leadership is required. That’s because, by and large, the real innovation challenge facing our businesses is cultural. And to change culture requires leadership.

If Australian business leaders are serious about tackling the digital and innovation challenge in 2018 we would do well to embody some clear character traits from those who do it best. Risk taking and failure will be expected and even celebrated. There will be a bias for action and experimentation. And leaders will actively listen to their people, customers, and communities to establish a real dialogue for idea generation and learning from experimentation.

The organisations that do this well will set themselves up for growth. They will be better prepared to face disruptive forces and potentially harness those same forces for their own benefit.

Cost competitiveness

What Australia produces, and how much we produce it for, are both factors in how successful we will be as a country in the global marketplace. The 2018 outlook survey respondents identified cost competitiveness as one of the top three policy issues for resolution in Australia next year.

KPMG analysis shows Australia underperforming from a productive output perspective compared to countries with similar standards of living. This would suggest the concerns regarding labour cost competitiveness, raised by our survey respondents, are justified.

Zooming in on the manufacturing sector, Australia is even less competitive. KPMG’s analysis finds that on an international basis, the hourly cost of labour is uncompetitively high relative to the final value achieved for the manufacturing output produced.

Traditionally, while Australia has had a high cost of labour, it has had a below average cost of electricity for industrial users. Unfortunately, this favourable cost-competitive position has been eroded over the past two years as domestic prices of electricity and gas have soared.

Disadvantages in cost competitiveness can be ameliorated through a country’s corporate tax system – if it is more competitive than in other jurisdictions. Unfortunately, our survey respondents also suggested that instead of helping, Australia’s corporate tax system actually acts as a further impost on their ability to earn internationally competitive returns. The Tax Foundation’s International Tax Competitiveness Index places Australia in seventh place overall in comparison to the 35 countries surveyed. However, Australia is ranked 25th on the basis of its corporate tax system.

All the negative factors weighing on Australia’s corporate landscape are fixable. But to do that, the Australian Parliament needs to implement a strong reform agenda. At present, a comprehensive reform agenda is missing, and unless it emerges our luck may start to run out.
Energy

Survey respondents have called out energy cost, reliability, and policy uncertainty as key issues.

Unfortunately, the bottom line pressure on companies will continue in the short-to-medium term. Most energy modelling analyses do not forecast major easing in energy prices until 2020.

The year ahead will require organisations to assess their energy procurement strategies and seek power agreements that enable them to lock in prices with sufficient contract flexibility to take advantage of any potential easing from the backend of 2019. New renewable generation is expected to progressively come online over the next two years.

In the event of power outages, the cost to businesses could be significant. This was the case during the South Australian storm and load shedding events last year. If businesses do not have adequate contingency plans they could go under, with small and medium size businesses the most vulnerable.

The coming year will see many trials that will scale into larger implementation across a wide range of technologies. Distributed energy solutions, microgrids, peer-to-peer transactions, demand-side management, Internet of Things, automated analytics, and communication infrastructure are just some of the technologies that will feature heavily in the energy ecosystems of tomorrow. Many of these new technologies are referred to as ‘grid edge innovations.’

In both the short and the longer term we need to bring on new dispatchable sources of energy generation and strengthen the reliability of the National Energy Market (NEM). We must make energy more affordable to business and consumers. And we need to start establishing an orderly transition to more renewables in our generation mix.

Next year must not follow in the footsteps of its recent predecessors. It needs to be a year of genuine action.

Regulation

Survey respondents from outside the financial services sector mostly agreed regulation had gone ‘completely overboard.’ Many thought it was often introduced to counter media noise or political agendas. A strong theme was that government too often turned to blunt ‘one-size-fits-all’ measures, which penalise whole sectors for the sins of a few.

Survey respondents from within the financial sector agreed the scale and complexity of regulation was a serious issue for Australia and would only get worse in 2018, with a slew of changes due. The survey was carried out before the announcement on November 30 of a Royal Commission, which will clearly add further to the already extensive regulatory agenda facing the sector.

While the bulk of post-GFC stability reform has been completed, there remains significant regulatory reform to come in key areas such as executive accountability, open banking, and privacy. KPMG expects conduct-related investigations will continue in 2018 in response to the loss of trust by the community. The challenge for executives and boards is how they manage the costs of regulation while delivering on the business transformation required to remain competitive in the digital environment.

Banks have already strengthened their balance sheets, building capital, liquidity, and moderating leverage so as to be ‘unquestionably strong.’ A further series of requirements next year would add to costs, and discourage measured risk-taking.

The European Markets in Financial Instruments Directive (MiFID II) will significantly affect Australian banks with exposure to Europe. It has implications for research, KYC processing, data management, record keeping, trade transparency and reporting, and best execution. Similarly, Brexit will present banks with a UK presence with a suite of regulatory risk projects to complete in short time.

Locally, ASIC has a suite of new conduct risk regulatory requirements: the Design and Distribution Obligation upon financial service providers for financial products, the Responsible Lending investigations, and Enforceable Undertakings for FX. New regulation will also apply to the bank bill swap rate.
Government efficiencies

When it comes to dealing with government, survey respondents identified confusion, duplication, and red tape as major concerns.

Respondents were particularly frustrated by the inefficient allocation of responsibilities between the different levels of government, suggesting that the navigation between state and federal responsibility continues to be an obstacle to Australia’s business efficiency and ultimate prosperity.

Many respondents saw duplication as getting in the way of fiscal prudence. They also highlighted that local government inefficiencies have a detrimental impact on business, as registrations tend to be slow and costly, thereby placing an unnecessary administrative burden onto processes that might otherwise be straightforward.

The concerns of respondents did not just concern government directly. The plethora of quasi-government agencies and businesses that work with government further compounded the sense of confusion and duplication in service delivery.

Government needs to continue to review and transform their service delivery in response to the changing needs of citizens and broader demographic changes. Healthcare, education and other social services should remain critical priorities. Work on energy policy and creating employment opportunities, given the changing nature of work, needs to continue – with a specific focus on regional Australia.

Governments need to continue to look hard at what services are delivered, how much they are delivered for, and who is best placed to deliver them.

Public trust

The survey has shown public trust is a key concern. We would argue it is, in fact, in crisis.

Certainly this is consistent with the findings of the 2017 Edelman Trust Barometer, which indicates public trust in all of Australia’s major institutions has fallen, or even collapsed.

Trust in business, in government, in media, in not-for-profit organisations – all have dropped to record lows. In fact, we have just experienced the largest drop in trust in the Barometer’s 17-year history.

There is increasing disbelief in the views of experts. Employees have more credibility amongst the general population than C-level executives. There is uncertainty about what fake news is, and what is not.

Openness in trade, foreign, investment, and immigration are commonly seen as economic threats that erode social values. There is an overall sense of brokenness about the system which gives rise to populist sentiment and fear. Politicians seem increasingly able to ignore established conventions; attacking judges, for example, when they make rulings with which they disagree.

So what can be done to rebuild trust? This is a difficult question, particularly in a world of 24/7 sound bites and social media.

For government, we need better ways to engage citizens in meaningful two-way dialogues to understand the key issues and to work with citizens and stakeholders to develop policy responses which will address these key issues.

For business, we need to ensure consumers feel they are genuinely being heard. They must feel that their needs are being taken into account and that they are dealing in a transparent world of integrity, instead of spin.

This necessary cultural realignment is a huge challenge, not just for 2018, but also for the years ahead.
Infrastructure and liveable cities

Governments and the private sector are recognising that getting our cities right is the productivity challenge of the 21st century. Competition in this century is between cities, not nations, as ‘place’ becomes the defining consideration for crucial consumer and investment decisions.

In 2017 a ‘Cities Agenda’ emerged and moved to the centre of the nation’s infrastructure policy. This has been led by the roll-out of the Commonwealth Smart Cities Plan, and bolstered by transformational investment in City Deals and Smart Cities and Suburbs grant recipients across the country.

State governments and city leaders have also contributed with urban renewal and infrastructure growth agendas: the Western Sydney Airport, the Melbourne Metro project, the Brisbane Metro and Cross River Rail initiatives, and the expansion of Metronet in Perth, to name a few.

These projects are no longer just infrastructure investments to deliver a construction employment boost or savings in travel time. Rather, they are driven by policy imperatives around housing affordability, employment growth, and attracting the brightest talent.

In 2018, expect an increasing focus on infrastructure funding and financing. With the rise of electric and autonomous vehicles, the pressure will be on state governments to address an unsustainable road pricing model. An increasing focus on market-led proposals can also be expected as all tiers of government look to the private sector for innovation in service and infrastructure delivery.

Government will also need to turn its attention to regulatory arrangements that maintain pace with the technologies changing the way our cities function. These disruptors will pull government towards new market structures, as we have seen in the case of mobility brokers, such as Uber. The rapid escalation of data being generated and retained in our cities will create new challenges and opportunities.

Fiscal sustainability

The fiscal sustainability of federal, state, and territory governments’ spending was raised as an issue of concern by various respondents.

Political realities determine that Australia’s fiscal deficit will not be addressed by the simple slashing of existing spending. Where it may be possible, however, is in the redesign and modernising of major programs and the embrace of an Australian innovation agenda.

KPMG supports the Productivity Commission’s view that Horizontal Fiscal Equalisation (HFE), which underpins the distribution of GST receipts to states and territories, is the right approach.

Under HFE, the government assesses the fiscal capacity of each state so it can distribute GST revenue to strengthen the capacity of those states with weaker fiscal capacity.

Trying to bring all states up to the fiscal capacity of the strongest state is proving an impossible ideal, so to revise the target to the second highest – or alternatively the average – state is a sensible approach. This will still provide the states with a high level of fiscal capacity, but not allow distortion due to the extreme swings of the leading state.

KPMG is urging a revamp of the Council Of Australian Governments (COAG) by recommending a Combined Australian Government Accounts that would disclose total revenue by source and function, and other new accounts and simplicity indices, to measure the ease of doing business in Australia.

This relatively simple change would drive efficiencies in its own right, but also create better general awareness about taxation, which is needed to build a case for reform. A dedication to fiscal transparency would help us look past our self-interests and work together to secure prosperity for generations to come.

As a longer-term proposal, KPMG argues that all taxes should be collected by the Australian Tax Office (ATO). This would subsume all tax collection rights from the states over the next five years, with the federal government bearing the administration costs. This reform would generate substantial efficiencies for businesses and individuals.
Big Data

KPMG is not surprised that Big Data – the data available for commercial opportunities and privacy concerns – has moved into a top 10 priority issue for Australian business in 2018.

The ever-increasing proliferation of data collection and processing on the back of digital innovation cuts both ways for Australian business. Big Data opens a world of new business opportunity for those ready to develop and enhance commercial offerings on the back of new insights, but there is also a raft of risk issues awaiting those who are not ready.

Meanwhile, with the impending Privacy Amendment (Notifiable Data Breaches) Act 2016 becoming effective from February 2018, many organisations will find themselves falling short of an ability to comply in instances where a data breach occurs.

Successful preparation for these changes is about far more than just regulatory compliance. It is a complex equation which mandates that organisations have a deeper understanding about the nature of the volumes of data they collect, store, and process. Businesses must be able to actively protect their data, whilst simultaneously making it accessible.

Data breaches are increasingly commonplace and large volumes of sensitive information are a target. Should a breach occur, complying with the requirements of the legislation is one thing, but equally important is how the organisation moves proactively to protect its reputation and retain the trust of its clients following an incident.

These considerations can be further complicated when IT, security, and data governance are not a core focus of the organisation. In such instances there is an increasing reliance on outsourced providers which presents additional challenges.

The rise of Big Data as a priority in this survey reflects a recognition from Australian organisations that they have not yet achieved the critical balance between Big Data, availability, innovation, and security – and that they are now running out of time.

Health

In terms of efficiency and services, KPMG observes the health sector increasingly using data and technology platforms to improve the delivery of healthcare. The sector, however, continues to face significant challenges.

Frequently, primary, secondary and tertiary institutions all use their own data platforms and systems, making the transfer of patient data across providers difficult. The Productivity Commission has recommended that governments should better cooperate to streamline the use of data and reduce duplication.

Significant investment has been made in technology applications by various governments and organisations, but in many cases this has not achieved the expected returns on investment.

But progress is being made, and in 2018 we expect this to continue. The roll out of My Health Record, a secure online summary of an individual's health information, continues apace, and the Australian Digital Health Agency has an ambitious agenda for improvement in this area. The future will require more granular patient data.

In line with international trends, Australia is starting to see a push towards funding for healthcare services based on patient outcomes and value, rather than activity. Data platforms that allow transparent and reliable recording and sharing of these outcomes across the sector, for both providers and funders, will be essential to the success of these new funding arrangements.

Incentive payments are likely to be part of new funding mechanisms. Both these and cost savings through more effective healthcare must be attributable to the right provider/funder to ensure ongoing participation in the new arrangements.

Changes taking place within the disability and aged care sectors also provide opportunities for the health sector to improve integration across the spectrum of care and support services. For this to happen effectively, it is essential the data and technology systems within and across organisations are in place to record patient progress and to share information with organisational performance funders.
The Top 3 issues: analysed
Issue 1
Digital and Innovation
It is not surprising to see ‘Digital and Innovation’ ranked as the clear number one priority issue for resolution in 2018.

As we look into 2018 we see the pressure on Australian business has increased. Two significant events have taken place and a third may be just around the corner. The American giant Amazon has entered the Australian market just in time for Christmas and the New Year sales. The Tesla battery array in South Australia has gone live. And sometime next year it is likely that Facebook will allow its 15 million active Australian users to use its Facebook Messenger service for payments.

These events may herald a new wave of change and transformation across the banking, retail, and energy sectors. They also show what is at stake when Australian businesses indicate they need to get their digital and innovation houses in order. Yet whilst ‘digital’ has certainly gone mainstream in terms of the executive agenda, innovation is an area where we continue to lag as a nation.

There are some positive signs, with several of our largest companies setting up venture arms and innovation labs. Some have even invested in training for new ways of working, such as Agile methodologies or Design Thinking. To make these efforts stick, however, concerted leadership is required.

That’s because, by and large, the real innovation challenge facing our businesses is cultural, and to change culture requires leadership. In the context of innovation it is what we say and do as leaders that will set the tone for the whole organisation. How do we talk about innovation? What do we say at the board table, with our people, and in our communities? And how do we act? Is there alignment between what gets said and what gets done?

The first thing to do is to make a commitment to innovation. Make it clear inside and outside the organisation that innovation is important. This commitment must also be backed up by providing funding, providing access to tools, and setting measures that reinforce the desired behaviour. Remuneration processes and goals for leaders and staff alike need to reflect the desired outcome. It needs to be clear how innovation connects back to your business strategy and what role everyone in the organisation plays in terms of idea generation, experimentation, and distribution of innovative solutions.

Your organisation also needs to make it safe to innovate. This means looking at how you deal with failure and risk-taking in the organisation. This is why methodologies such as Design Thinking and Agile are important: because they give people tools and processes to follow in developing out ideas and testing approaches.

Having spaces that encourage innovation, such as a lab, are also a good idea. These spaces give a clear signal to people that here is a space that is safe for experimentation, idea generation, and prototyping. A lab, coupled with clearly defined innovation domains, also sets clear boundaries for where the organisation wants to innovate. Most importantly for leaders, the key is how we respond to failure. If it is not safe to fail, it is not safe to innovate. And organisations that don’t innovate cannot learn and grow.

“Customer behaviour is moving quickly and innovation and digital enables us to scale and respond.”

(survey respondent)
So the intention we need as leaders and within our organisation is to be curious. If the key to growth and long-term survival is adaptability and change the necessary mindset is curiosity. By being curious we create the opportunity for change in an organisation. It means we naturally start to assume an outwards orientation. We pay more attention to customer behaviour and ask “why did they do that?” We also have the opportunity to more quickly identify and pick up on the trends that matter. A curious organisation will look beyond what it does for the customers of today and seek to understand what it will be providing to the customers of tomorrow. Curiosity allows an organisation like Amazon to go from selling books in the 1990s to providing web services today.

But it is not enough to provide direction, safety and be curious. An innovative organisation must also have a bias for action. This means taking steps to test hypotheses and run experiments.

So as leaders we need to be asking what ideas do we have and how are we testing these? Who is accountable for running experiments in our organisation? How many are we running? What are the results of these experiments? And what are we going to do next? Because when we are faced with uncertainty it can be easy to do nothing and wait for a direction to become clear. The fast follower strategy has served Australian businesses well, but in a world where the stakes are increasingly shifting to ‘winner takes all,’ we need to find our own way and deliberately step out into the unknown.

To navigate uncertainty means coupling action to future focus. Special attention needs to be focused on the weak signals of today that have the potential to shape tomorrow.

Innovation is most powerful when used to drive growth. To spot growth opportunities means we need to be both cognisant of and close to, changes in society, regulation, technology, and economics.

We need to have a careful eye on whether these changes have the potential to create opportunity or disrupt current business practices. Looking at patent lodgements, venture capital flows, new technology developments, and customer trends can help identify where to focus.

The role of leadership in this process is to continually ask the organisation: “what should we try next?” Driving efficiency and productivity will only take an organisation so far. In a growth context, it’s a zero sum game.

Finally, to take advantage of opportunities, find weak signals, and to capture ideas, means rethinking our relationship with our people and how we engage with them. A lot of time and effort in an organisation goes into how best to communicate to our people. A consequence of this is that we have made it hard to listen.

To innovate effectively means having a focus on establishing a dialogue where leaders effectively communicate to the broader organisation where and how they want to innovate, and the tools and support available. From here it is about being able to listen to the ideas our people have and to be open to hearing their input and perspectives.

Most organisations are not good listeners. Most of our communications infrastructure tends to be dedicated to getting messages from the top of the organisation to the bottom, and not the other way around. However, it is often our people who are closest to the customer. They are the ones who will see opportunities that are not immediately apparent to the executive. This is where in-house crowdsourcing, hack-a-thons, and accelerator programs can give people a voice and opportunity to contribute to the future growth agenda of an organisation beyond their day-to-day roles.

“Trying to cram our existing practices and models into digital assets is like stuffing an elephant into a shoe box…”

(survey respondent)
So if Australian business leaders are serious about tackling the digital and innovation agenda in 2018 we would do well to embody some clear character traits from those who do it best:

• there must be a clear commitment to innovation, where our leaders’ actions match the message;
• risk taking and failure will be expected and even celebrated for the learning and growth opportunities it can provide;
• our organisation will have an outwards orientation, underpinned by a curious mindset, and focus on the customer;
• there will be a bias for action and experimentation;
• the organisation will look not just outwards but over the horizon to see what’s next; and
• leaders will actively listen to their people, customers, and communities to establish a real dialogue for idea generation.

The organisations that do this well will set themselves up for growth. They will be better prepared to face disruptive forces and potentially harness those same forces for their own benefit.

Having organisations like Amazon, Facebook, and Tesla increase their presence in our market is a timely reminder that when you get it right, innovation can be a powerful force for growth in any business.
Issue 2

Cost competitiveness
Australia is a lucky country, but we are also a competitor in the global economy. Obviously, our goods and services compete against those produced in other countries. But we also compete for global capital looking for a nation to invest in.

What Australia produces, and how much we produce it for, are both factors in how successful we will be as a country in the global marketplace. Survey respondents this year identified cost competitiveness as one of the top three policy issues for resolution in Australia next year.

Cost competitiveness is a relative issue. That is, costs are important relative to the same cost in competitor countries, but also costs are important relative to the value of output produced, both here and overseas. Chart 1 shows the relationship between GDP per capita, which is a measure of living standards, and output per worker employed, which is a measure of labour productivity.

The yellow dot on the chart represents Australia, with blue dots representing the remaining 167 countries in the sample, and the dotted line showing the trend relationship between the two variables. This analysis shows Australia is sitting slightly below the trend line, which means for our given level of GDP per capita, our output per worker is less than it should be if we were to have average competitiveness. KPMG Economics has calculated this shortfall in 2015 to be about 7 percent, substantially better than 2010, where Australia’s shortfall was nearly 16 percent.

**Chart 1**

**GDP per capita and labour productivity, various countries, 2015**

Source: IMF, ILO, KPMG Economics
Nevertheless, this analysis shows Australia underperforming from a productive output perspective compared to countries with similar standards of living. This would suggest the concerns regarding labour cost competitiveness raised by our survey respondents are, at first blush, justified. We have also looked at the total hourly compensation costs in the manufacturing sector for 21 countries, and considered these costs in the context of gross value added (GVA) per hour worked. Unfortunately, this analysis (Chart 2) further reinforces the poor labour cost competitiveness story for Australia. Chart 2 shows the relationship between labour cost per hour and GVA per hour for the manufacturing industry in 21 countries, with the yellow dot again representing Australia.

In this analysis, Australia is much further below the trend line compared to the whole-of-economy analysis. This below-trend outcome for Australia indicates the hourly cost of labour is too high relative to the final value achieved for the manufacturing output produced (again relative to the countries considered in the dataset).

The differential between what compensation rates should be for the manufacturing sector and what compensation rates are is significantly more pronounced than in the whole-of-economy analysis.

This, albeit limited, analysis suggests manufacturing compensation rates in Australia were about 32 percent and 43 percent higher than they ‘should’ be in 2010 and 2015 respectively. This means, over the relevant five-year period, the compensation costs grew faster than value added, meaning profitability for the manufacturing sector in Australia experienced a squeeze.

While labour costs can represent between 40 percent and 57 percent of the cost base for a manufacturing business, the cost of utilities, including electricity, gas and water, can also be important.

Chart 3 shows the combination of total compensation costs per hour in the manufacturing sector and the price of electricity for industrial users for a range of countries, including Australia (highlighted as the yellow dot). This analysis shows that while Australia had a relatively high cost of electricity for industrial users for a range of countries, including Australia (highlighted as the yellow dot). This analysis shows that while Australia had a relatively high cost of electricity for industrial users. Unfortunately, this favourable cost-competitive position for Australia has been eroded over the past two years as the domestic prices of electricity and gas have soared.
Keeping us up at night

As shown in Chart 4, the price index of electricity for manufacturing sector in Australia has kicked up since 2015. The latest State of the Energy Market Report released by the Australian Energy Regulator (AER) in May 2017, finds that during 2015-16 wholesale electricity prices rose by between 50 percent and 67 percent in almost every state and territory covered by the National Electricity Market (NEM).

Disturbingly, the AER study also reveals that the upward trajectory of the wholesale electricity prices was maintained into 2016-17, with the largest rises being experienced in South Australia, Queensland and New South Wales.

Chart 3
Manufacturing total compensation costs and electricity prices per mwh, various countries, 2015

Source: The Conference Board, KPMG Economics

Chart 4
Electricity prices for manufacturers, Australia, 1981-2017

Source: ABS Cat: 6427.0 Sept: 2017, KPMG calculations
The AER report provides a clear explanation of what has caused the higher wholesale electricity prices, including:

- a tightening in the supply-demand balance;
- a resurgence in peak demand;
- closures of coal-fired power stations, either permanently or temporarily for maintenance, resulting in the gas-fired power stations setting the dispatch price at a time when gas fuel costs were ‘extremely high’; and
- limitations of electricity imports into South Australia due to interconnector maintenance.

Chart 5 confirms our earlier comment regarding a profit squeeze in Australian manufacturing identified in the international data. Between the December quarters of 2010 and 2015, gross operating profits as a percentage of sales moved down from 9.1 percent to 8.0 percent, while total wages moved up from 14.2 percent to 15.5 percent.

Clearly, over the five years to 2015, returns to workers increased, costs of electricity to industry escalated dramatically, while returns to shareholders declined. However, it would seem from more recent data that wages growth, particularly within the private sector, has been weaker over the past year or so than it has been in more than half a century.

Australia is a small, open economy. It competes for equity capital seeking industries and countries in which risk can be adequately compensated. The divergence between returns to shareholders and labour has long been a problem for Australian manufacturing. This has been one of the key contributing factors to the sector’s relative decline in importance over the past three decades.

"Australia is a costly market to operate in from a labour and overseas reach perspective. Costs are increasing at a greater rate than retail or economic growth."

(survey respondent)
In a speech in November 2017, the Governor of the Reserve Bank suggested the sluggish wages occurring across the economy were likely to be a consequence of businesses not bidding up wages, as they have done historically, owing to increased competition. This is unsurprising given ongoing excess capacity in the labour market. Despite recent increases in full-time employment, the unemployment rate is still around 5.5 percent, and underemployment is at historically high levels.

A nation’s cost competitiveness relates to more than just its direct costs. Rational shareholders seek to maximise their risk-adjusted, post-tax return on equity. This means that while the underlying market conditions are most important from an investor’s perspective, tax still matters, albeit at the margin.

Sometimes, however, the margin can be wider than governments think it is, so tax begins to matter more. Disadvantages in cost competitiveness can be ameliorated through a country’s corporate tax system if it is more competitive than in other jurisdictions.

Unfortunately, our survey respondents suggested that instead of helping, Australia’s corporate tax system actually acts as a further impost on the ability to earn internationally competitive returns.

The Tax Foundation’s International Tax Competitiveness Index places Australia in seventh place overall in comparison to 35 countries surveyed. However, Australia is ranked 25th on the basis of its corporate tax system.

It would seem then that our survey respondents have a point. Australia’s cost competitiveness is below where it should be on the basis of labour costs and productivity. Our relatively low electricity cost environment has evaporated in the past two years. And our corporate tax system is globally uncompetitive and unsupportive.

All the negative factors weighing on Australia’s corporate landscape are fixable. But to do that, the Australian Parliament needs to implement a strong reform agenda. At present, a comprehensive reform agenda is missing, and unless it emerges in 2018 our luck may soon start running out.
Australia is in an energy crisis. In 2018, we desperately need concrete steps toward certainty on energy policy so the investment required by the sector can flow.

The current state of pain is clearly understood. For years now it has been a hot topic from the boardroom to the weekend barbecue.

We have seen mountains of reports, submissions, analysis, policy announcements, and tweets.

Australia’s loss of energy competitiveness is beyond dispute.

Respondents to the survey have called out energy cost, reliability, and policy uncertainty as key issues going into the New Year.

The coming year must not follow in the footsteps of its recent predecessors. It needs to be a year of genuine action.

We need to bring on new dispatchable sources of energy generation and strengthen the reliability of the National Energy Market (NEM). We must make energy more affordable for business and consumers.

And we need to start establishing an orderly transition to more renewables in our generation mix.

We need to achieve all this while also meeting Australia’s global emissions reduction targets.

High energy prices will continue to put significant pressure on business competitiveness

Most energy modelling analyses do not forecast a major easing in energy prices until 2020.

Unfortunately, the bottom line pressure on companies will continue in the short to medium term. The year ahead will require organisations to assess their energy procurement strategies, and seek power agreements that enable them to lock in prices with sufficient contract flexibility to take advantage of any potential easing from the backend of 2019. New renewable generation is expected to progressively come online over the next two years. Many large energy users are exploring opportunities for ‘behind the meter’ renewable energy generation at their sites.

In the event of power outages, the cost to businesses could be large. This was the case during the South Australian storm and load shedding events last year. If businesses do not have adequate contingency plans they could go under, with small and medium sized businesses the most vulnerable.

If uncertainty persists with progressing actions on energy reform, some businesses could look to change their investment decisions in Australia. This year, many business leaders have signaled this risk.

One survey respondent’s frank assessment summed the situation up well: “Security and cost of energy are creating serious disruptive effects to our businesses and required significant investment in contingency planning. This is something we would anticipate in an emerging market – not in Australia”.

As a nation we can, and must, do better.
Keeping us up at night

Energy demand management is gaining momentum. Some businesses have taken up incentives to respond to load shedding requests and are reducing their consumption. Demand management actions would help keep the grid stable and the lights on. While this is not for everyone, it does represent an option for businesses looking to achieve energy savings depending on individual company circumstances.

Gas supply and affordability will continue to be challenging

The east coast gas market situation remains challenging. The bottom line is that more supply needs to come from states outside Queensland if we are to both meet our domestic needs and export commitments. Clearly this is a complex issues as we are now part of a global gas market.

The industry came together this year in response to federal government pressures and this has been constructive. Positive collaboration can drive outcomes that benefit all stakeholders. Nonetheless, uncertainty abounds around state moratoriums and delays in getting gas projects up. Next year, the ACCC’s work will continue to put gas in the spotlight. Transparency and constructive industry response remains paramount.

Consumers will respond to market signals

Air conditioners may get less use this summer. Across the country, consumers are getting more engaged to check they are receiving the highest retail discounts, with some help from federal government pressure on retailers. Many are now taking action to better manage their energy efficiency.

Residential batteries are still expensive and the take-up has been relatively low in Australia. Until prices come down, they remain out of reach for many consumers. During 2018, the ACCC will release its final report on the retail sector and this will continue to place focus on customers.

Investment in renewables will continue at both the business and consumer level

The cost of solar and wind projects will continue to come down next year. The International Energy Agency (IEA) clearly confirmed the trend of cost reductions in its latest 2017 Energy Outlook report. Moreover, both Queensland’s and Victoria’s renewable auctions in 2018 will see extensive interest. These are significant projects that will help bring new renewable generation into the grid.
Pending outcomes of the NEG, new renewable energy investments may be impacted for a short time. Nonetheless, Australia is seen as one of the most attractive energy investment markets. With the continuing lowering of costs of renewable technology, combined with our wind and sun resources, we will see continued investment.

On the consumer front, more households will put solar rooftop on their houses, with installation continuing to rise as the cost of solar photovoltaic falls. A growing number of people want to take greater control of their energy use and rising energy prices will trigger more investment.

**Leaders will embrace technology innovation**

Trials involving new and innovative technologies are occurring across Australia. Utilities are experimenting, doing proof-of-concepts, learning, and implementing. Distributed energy solutions, microgrids, peer-to-peer transactions, demand side management, Internet of Things, automated analytics, and communication infrastructure are just some of the technologies that will feature heavily in the energy ecosystems of tomorrow. Many of these new technologies are referred to as ‘grid edge innovations.’

The coming year will see many trials that will scale into larger implementation across a wide range of technologies.

Business will embrace these new technologies for a range of reasons: improving customer service, dealing with greater complexity on the electricity grid created by more distributed energy resources, reducing operational costs, responding to increasing extreme weather events, and opening-up new energy models.

There is no surprise here. Digital and Innovation ranked as the number one issue in the survey. For some, embracing and harnessing technology innovation will be a question of business survival.

Pleasingly, across Australian utilities there are many examples of collaboration and knowledge-sharing on technology innovation. In the area of energy transmission and distribution there have been proven examples of collaboration with Energy Networks Association and CSIRO to map out future scenarios and explore both the challenges and opportunities offered by grid edge technologies.

One area of interest and focus next year will be grid modernisation. Many transmission and distribution businesses are currently looking at investments to upgrade their grid distribution management systems. This includes supervisory control and data acquisition (SCADA), advanced distributed network management systems (ADMS), and outage management systems.

Utilities that fail to invest in new visualisation, automation, and data analytics could face challenges in servicing customers, dealing with outages, and reducing their operational cost to manage the grid.

Ultimately, successful leaders will be those who experiment, those who fail and learn fast, those who engage their workforce, those who foster an innovative culture, and those who leverage leading technologies and insights from other sectors and markets.

**3 predictions for 2018**

1. Consumer participation in the energy sector will increase. The development of solar photovoltaic will continue by both industrial and commercial energy users, and households.

2. Large storage solutions will increasingly be connected to the grid.

3. New gas projects outside Queensland will contribute to energy supply.

“Energy is treated as an issue for political point scoring between the major political parties, to the detriment of the country.”

(survey respondent)
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