NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE INQUIRY INTO THE NEW ZEALAND ELECTRICITY INDUSTRY

JULY 2003

1 Introduction

1.1 This submission on the *Inquiry into the New Zealand Electricity Industry* is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand businesses. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The terms of reference for this inquiry (see the appendix to this submission) raise important issues that deserve a thorough investigation. In our press release of 7 May 2003, a copy of which is attached to this submission, we expressed our view that the current situation is unsatisfactory. As a half-way house between a centrally planned system and a more normal competitive market, it cannot deliver good outcomes. We advocated much reduced government involvement and provided a five-point indicative agenda of issues which, in our view, need to be addressed.

1.3 Instead, the government's 20 May 2003 announcements took the industry further down the path of state ownership and control. They were not accompanied by any evidence that the government had given serious consideration to 'more market' options. This is regrettable given that the government's stated top priority objective is to achieve faster economic growth.

1.4 The government's latest announcements have in some ways pre-empted the Committee's deliberations. For this reason our submission focuses on what we see as high level issues in the industry.

2 Electricity generation and dry year capacity

2.1 In our view the government should hold a formal inquiry into the causes of this year's fortuitously averted electricity crisis. The government owns 75 percent of the electricity industry and is heavily involved as a regulator. Relevant ministers, SOE boards and managers should be held accountable for shortcomings.

2.2 The establishment of the Electricity Commission and related decisions signal a return to a more centrally planned approach to the electricity system. In the past governments attempted to assure members of the public of all the power they wanted at a politically determined price. This is again implicit in the idea of creating reserve generation which would be activated if electricity prices rise above a specified level. Any attempt to control both price and quantity supplied is unstable. It can be expected to drive out private investment in capacity and to cause periods of marked under- and over-investment. The 'Think Big' projects were a manifestation of over-investment. Likewise major users will have less incentive to hedge against high prices and to invest in alternative demand management and generating arrangements.

2.3 In electricity markets, it is hazardous to interfere with the operation of the price mechanism, as experience in California showed. Electricity prices in New Zealand have not typically been more volatile than in other countries.[1] A major problem with the central planning approach to dry year capacity that the government is adopting is that no central planner can know how much the public is prepared to pay in order to achieve lower market prices in dry years. This can only be discovered through the voluntary market processes that a central planning approach regulates out of existence. In the absence of such knowledge, key decisions – such as the setting of a 1 in 60 dry year standard – are fundamentally arbitrary. This arbitrariness allows politicians and bureaucrats to take decisions that depart from the national interest.

2.4 The option of mandating the offer or acceptance of hedge contracts implies the mandating of what constitutes a reasonable price for the contracted power; otherwise the requirement would lead to farcical situations. This would represent a taking of private property rights if applied to private firms or persons. Issues of compensation for takings should then be addressed. If applied to state firms it would represent a transfer of wealth, possibly from taxpayers to large energy users. The issue of the appropriateness of such transfers should be examined.

2.5 The government's dry year measures aim to preserve some incentive for the private sector to invest in additional base load capacity. They do so by

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1 In New Zealand the concern has been with spot prices that can rise from 5 cents per kwh to 20, 40, 60 or 80 cents. Yet according to Morgan Stanley Dean Witter analyst, John Woodley, at 25 June 1998 prices in mid-continental USA spiked at over $7.00 per kwh and the trading range in the United Kingdom has exceeded $1.50 per kwh.

attempting to ring fence the dry year reserve so that it is unavailable in normal years. There are at least three problems with this: (i) it is a highly visible waste of capacity in normal years; (ii) if private investors regard it as politically unsustainable it will not have the desired results; and (iii) users who want security of supply in dry years can contract for it, or build their own capacity; others are not indicating that they wish to pay the price for greater security of supply.

2.6 However, given that the government is determined to proceed with the commissioning of dry year capacity we commend consideration of options that would make it available in normal years and that would allow users to opt out of the levy system. Such options would go some way to addressing concerns (i) and (iii). In evaluating these options, consideration would have to be given to the extent to which the reduced ring-fencing exacerbated the pervasive problem of state-erected barriers to private investment in base capacity. It is important that proper processes are followed to ensure that options chosen are least-cost. The decision to contract with Contact Energy for supply from its Whirinaki site seemed ad hoc. We stress that we only commend the investigation of this alternative as second best.

2.7 It is clear that there was no major problem with lack of generating capacity this year; instead it was with the low lake levels and the supply of gas and coal. For this reason it is hard to understand the government's focus on adding to dry year generating capacity.

2.8 In our view the most important concerns in the industry are the increasing barriers to private investment in additional generating capacity in response to demand growth. Besides the new uncertainties created by the establishment of the Electricity Commission, the barriers include uncertainty about political intervention in state-owned generators, the Resource Management Act, the ratification of the Kyoto Protocol, the propensity of governments to take private property rights without compensation, government biases as to the type of new investments it would like to see (eg renewable energy), the lack of coordination between energy, conservation and environmental priorities, and high investor tax rates (now 39 percent for domestic investors).

2.9 Given these concerns we think the direction of the government's moves is fundamentally wrong. Less state domination of the industry, not more, is required. Electricity is predominantly a private sector industry in other OECD countries; few if any approach New Zealand's level of 75 percent government ownership. What is needed is a willingness by the government to set aside its anti-private ownership ideology and allow officials to advise it on the relative merits of market and central planning approaches to investment in generation. In our view the Committee has a duty to the public to insist that an impartial analysis of the options be undertaken.

3 The regulation of lines companies

3.1 The Committee's terms of reference require it to determine a regulatory regime which ensures that in future lines companies receive a fair return on invested capital and that consumers are charged fair prices. This implies that any return above a fair return is unacceptable. Yet lines companies may also receive less than a fair return in harder times. This asymmetry is likely to deter investment.

3.2 On the other hand, the Committee could not simply recommend that lines companies achieve a fair return at all times since this would remove the incentive to control costs. Moreover, if the fair return were set at the normal competitive return there would be no incentive for investors to invest in electricity lines rather than government stock. Risk-adjusted, the returns would be the same. Investors would therefore be indifferent.

3.3 There is no escape from the need to allow investors to make profits that are above normal competitive levels in good times in order to balance the risk of making inadequate profits at other times. Unfortunately, a regulator cannot hope to determine this balance with any precision since it is a subjective entrepreneurial judgment.

3.4 For these reasons, we think the Committee should express serious concerns about the effect of the proposed rate of return regulation on willingness to invest. This is not to advocate other approaches such as CPI-X or ODV regulation. What is needed is a fundamental inquiry into the need for such options and their relative merits.

3.5 The terms of reference do not require the Committee to address the earlier forced separation of lines companies from energy retailing and generation. However, this separation was never adequately justified in public policy terms and it has seriously distorted the market and led to the renationalisation of parts of the industry. The recent partial relaxation opens up possibilities for distributed generation and is a step in the right direction, but even here the incentive to invest is much reduced by the regulatory barriers.[2] There are important economies in vertical integration of the electricity industry. We consider that there should be an investigation into whether current restrictions should be relaxed further. This would include an examination of whether mergers between lines and energy companies should be allowed, subject to Commerce Commission approval.

3.6 We note with some disquiet that the Commerce Commission is being asked to appear before the select committee as part of its inquiry. The Commission is established at arm's length from the executive and parliament and we regard it as important that it remains free from political pressures and is held accountable only through established and transparent procedures.

4 Concluding comments

4.1 It is difficult to reconcile the government's statements that economic growth is its top priority with its anti-private sector approach to electricity and its associated unwillingness to tackle the impediments to investment indentified in paragraph 2.8. We see no chance of the industry achieving dynamic efficiency in this environment. The ever-increasing regulation and the uncertainty it creates must be choking off some business investment. At the same time, taxpayer money will be wasted in uneconomic investments. Both effects will impair economic growth.

4.2 We urge the Committee to press the case for an inquiry into the real sources of the dry year problem and insist on a standard of public policy analysis that considers all the relevant options. These include the desirability of private ownership and production of private goods. Electricity is a private good as are

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2 See, for example, *The Independent*, 'Close-to-home power tipped to fill supply gap', 30 July 2003, p 4.

electricity lines. A central authority cannot discover the information about willingness to pay that is discovered through market processes and cannot adequately second-guess differences between entrepreneurs about how the future will unfold. Legislation by the government to establish the Electricity Commission and impose further regulation on the industry should be supported by a competent Regulatory Impact and Compliance Cost Statement.

Appendix: Terms of Reference

The terms of reference for this inquiry require the Commerce Committee to consider:

1. what the electricity generation companies do in order to ensure balance is struck between thermal and hydro generation, to give security of supply in dry years
2. the asset utilisation by electricity generation companies and their planning for capacity development
3. the workability of corporate separation of generation and retail activities of the electricity generation companies
4. if and where the retail sector is acting competitively and to ensure that such competition is genuine and that barriers to switching suppliers are extinguished
5. whether the profits secured by electricity lines businesses since corporatisation have been excessive
6. the basis on which the Government authorised lines companies to value their assets when corporatising in 1993 and how they were expected to set charges as a result
7. how asset revaluations since corporatisation have been accounted for as they were taken into the lines companies' books, and how they should have been treated for the purposes of price-setting
8. what, if any, further reforms to the regulatory regime are required to ensure lines companies in the future receive a fair rate of return on invested capital and that consumers are charged fair prices.

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FOR IMMEDIATE RELEASE

ENERGY POLICY MUST BE ALIGNED WITH GOVERNMENT'S GROWTH OBJECTIVE

7 May 2003

"The present electricity crisis demonstrates that too many of the government's policies are incompatible with its stated priority of economic growth", the executive director of the Business Roundtable, Roger Kerr, said today.

"It is intolerable that businesses, as well as households, are facing disruption and high prices only two years after a similar crisis, with no satisfactory remedy in sight. This indicates serious mismanagement.

"The government says it wants to achieve a sustained economic growth rate of 4 percent or more, meaning the economy would be nearly 50 percent larger in 10 years' time.

"This could require electricity production to be perhaps a third higher than it is today. Expanding generating and transmission capacity at the necessary rate requires major policy changes to allow investment to happen.

"In the short term, businesses and households must respond to the government's calls to conserve power. Higher prices should be passed through to households so that they have a better incentive to conserve power and businesses and jobs are not put unnecessarily at risk. It is pleasing that the government appears to be exploring short-term options for boosting supplies. However, it is important that it respects private property rights and enhances long-term incentives to invest.

"After the crisis has passed there should be a formal inquiry to identify its causes and the actions needed to prevent a recurrence. The government owns 75 percent of the electricity industry and is heavily involved as a regulator. Relevant ministers, SOE boards and managements should be held accountable for shortcomings. The planned parliamentary select committee inquiry is not an adequate vehicle for this purpose."

Mr Kerr said that the current electricity system was an unsatisfactory half-way house between a centrally planned system and a more normal market. "This cannot deliver good outcomes. Recent years have seen increasing ad hoc interventions and reports of further actual and prospective interventions are alarming.

"Instead, the thrust of policy should be to reduce government involvement in the sector and remove unwarranted regulations and barriers to investment in new generating capacity. This agenda should include:

- changes to the Resource Management Act that go well beyond current proposals, and to the Kyoto Protocol policy package;
- a coordinated review of other policies that are blocking new energy supplies including conservation, marine reserves, local government, transport and the role of the Commerce Commission;
- much greater protection for private property rights in order to reduce business uncertainty (eg over cogeneration) and attract private investment;
- improvements to market rules and the operation of Transpower; and
- a substantial transfer of Crown-owned energy assets to private ownership.

"Proposals for another round of basic restructuring of the sector or to impose price controls are misguided. They would only add to uncertainty and create further disincentives to investment.

"New Zealand has no inherent shortage of energy supplies. The sector's performance has improved markedly relative to the former control-and-command regime. However, it has been subject to repeated political interference and successive governments have not taken action to remove bottlenecks.

"For nearly four years the business community has been saying that too many of the government's policies are not conducive to growth. Increasing regulation across the board is choking off business investment. There needs to be substantial adjustments to policies affecting the energy sector to align them with the government's plans to get New Zealand back into the top half of the OECD income rankings", Mr Kerr concluded.