NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE POST-WINTER REVIEW OF THE ELECTRICITY SYSTEM

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POST-WINTER REVIEW OF THE ELECTRICITY SYSTEM

Executive Summary

- This submission on the minister of energy's post-winter review of the electricity system is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall New Zealand interests.

- We have publicly commended the minister for his handling of the winter electricity shortage. Although the government inherited an imperfect market, it was wise to reject calls for further ill-conceived interventions at a time of market disruption. The market handled the shortage better than during the electricity crisis of 1991.

- Nevertheless, we see grounds for serious concern about future private sector investment in the electricity industry. The continuing trend towards altering incumbents' property rights without compensation and impediments to new investment under the Resource Management Act make for an increasingly hostile environment for investment.

- In our view the high level of government ownership of the electricity industry combined with overly intrusive regulation create high risks of a repetition of this winter's events.

- These concerns also apply to the previous government's decisions affecting the sector and are not a simple matter of blaming government. There will always be pressures for greater intervention from self-interested parties and those with naive views about competition and market behaviour, as long as politicians are receptive to them.

- There have been significant improvements to the electricity system, and suppliers and users have learned lessons from the recent shortage that will help avoid further mistakes. There is now time for careful analysis of the scope for further improvements.

- This should be conducted in a rigorous manner free from political constraints. In our view the most serious outstanding problem is the extent of state domination of the industry which restricts its development and impairs market competition. State domination has increased as a result of recent events. With electricity being predominantly a private sector industry around the world and with ongoing moves in this direction, the government should not set its face against privatisation on ideological grounds.

- Although we regard the government's plans on climate change as precipitate, the improvements in energy efficiency that could be obtained from a private, competitive industry could far outweigh the gains from the more interventionist and costly measures that the government is contemplating.

- Any proposed changes to electricity industry regulation arising from the review should be shown to meet the requirements of Regulatory Impact Statements. For the RIS process to have credibility, options for increasing competition through reductions in state control of the industry must be considered.

1 Introduction

1.1 This submission on the minister of energy's post-winter review of the electricity system is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.3 The review is to consider whether further changes are required to New Zealand's electricity market arrangements. The minister has stated that a number of electricity consumers and industry participants are asking whether the market worked properly under dry-year supply pressure.

1.3 In September we publicly commended the government for its handling of the winter electricity shortage, in particular for resisting ill-considered calls for price controls, profit rebates and other interventions. We agree that it is timely for careful reflection as to the lessons to be drawn from this experience.

2 Weaknesses in current arrangements

2.1 In our view there are important weaknesses in current arrangements, particularly when taken as a whole. The most serious one is the extent of government ownership of the industry but they also include aspects of regulation.

2.2 ***Government ownership*** Government ownership creates the following difficulties:

- conflicts of interest for the Crown;
- lack of accountability as a result of mixed objectives for the State-owned Enterprises (SOEs) themselves;
- politicisation of pricing and investment decisions; and
- heightened risks for private sector participants.

2.3 Government ownership creates a conflict of interest for the government over policies that could benefit its own companies relative to competitors and consumers. Its interest in obtaining votes from household consumers, who have more voting power than non-residential users, influences its attitude towards the pricing decisions of SOEs and puts taxpayers at risk. Other political parties exert pressure for non-commercial interventions, as occurred during the crisis when there were calls for SOEs (but not private generators) to rebate 'windfall' profits.

2.4 The same issue arises at the level of SOE boards. Ministers appoint the boards of the SOEs. This exposes them to similar conflicts of interest as they are inevitably sensitive to political considerations to a greater or lesser extent.

2.5 The presence of conflicting objectives makes it difficult for SOEs to price risks commercially. For example, suppose an SOE sells a hedge contract to a competing retailer. How is the board (or the retailer) to know that the same SOE will not undercut it in the event that there is no power crisis by underpricing the risk to its own retail customers?

2.6 During the recent shortage, the SOEs had the option of passing on the higher wholesale market prices to households, as On Energy attempted to do. In the event the use of the price mechanism as a means of rationing a scarce resource was largely suppressed in this part of the market. This also precipitated the renationalisation of On Energy's retail electricity business.

2.7 Since the alternative to rationing by price is to ration by quantity, the limitation of the price response to non-residential customers also forced the government to call more vigorously for voluntary rationing. Voluntary quantity rationing rewards those who use power wastefully. This is inefficient and inequitable. Forced quantity rationing is an even less attractive option.

2.8 Why were prices to households not raised during the shortage? At this stage answers to this question are necessarily speculative and should be examined by the review. One reason that has been suggested, namely that generators could not justify higher prices because their costs had not risen, is political. It has no basis in economics or commerce. It confuses accounting cost with opportunity cost. Market prices are not determined by production costs but by supply and demand. Sometimes market competition may force firms to sell below cost; on other occasions they will be able to sell above cost. This reflects the operation of normal market processes.

2.9 An alternative argument is that the SOEs did not raise retail prices because they wanted to force competitors such as On Energy out of business. This might be a valid commercial strategy or an anti-competitive manoeuvre. Neither of these explanations is particularly plausible in the absence of collusion between SOEs or other special circumstances. Moreover, no individual SOE could be sure of picking up the customers of a failed retailer cheaply, given competitive bidding.

2.10 Nevertheless, the possibility or suspicion of predatory behaviour underwritten by taxpayers must act as a deterrent to private sector investment in the electricity industry. Even if the problem is more one of perception than of reality, it cannot be eliminated as long as Crown ownership persists.

2.11 A further possibility is that the SOEs did not want to lose retail customer goodwill. This is undoubtedly a valid commercial consideration. The accountability issue arises because it is unclear whether such a reason explains the pricing outcomes – as might be assumed in an industry made up of private firms – or whether other factors were at work.

2.12 An unrelated commercial argument is that one or more SOEs may not have raised the retail price because they did not effectively control it. This might be because of hedge contracts. If a generator has already used such contracts to sell power forward at a given price, the rights to resell that power at a higher price might lie elsewhere. The question then becomes why resellers did not respond to opportunity cost considerations and raise prices.

2.13 The lack of response of retail prices during the shortage would not be a concern if it reflected an explicit fixed or capped pricing agreement with household users. Under such a contract the risks of shortages would lie with suppliers (unless they shifted the risks through hedge or other contracts) and the costs of this form of insurance would normally be charged to retail users. The last point is critical. If household bills do not include the costs of this insurance cover, they must be being borne in some proportion by other users or by investors at the expense of allocative and dynamic efficiency respectively.

2.14 Talk of paying households to conserve power during the winter shortage suggests that current household bills include an insurance premium element. In a more normal competitive market, it might be expected that households would be offered a range of insurance contracts so as to allow them to selfselect, at least to some degree, their exposure to risk during shortages. Those taking more risk would get their power more cheaply on average. Obviously, concerns about credit risk would influence the terms of the contracts offered.

2.15 The main point we draw from these speculative remarks is that the fact of government ownership makes it difficult to assess whether the electricity market is operating efficiently and to hold SOEs accountable for their pricing decisions. It may be impossible to unravel the relative importance of political and commercial considerations in any decision. This creates risks for purely commercial competitors. As electricity is a private good and generation is a competitive activity, there is no justification for government ownership of its production. The risks for taxpayers can only be compounded when the Crown owns multiple generating companies that compete with each other when bidding to buy assets.

2.16 Finally, Crown ownership of Transpower exacerbates the threat to dynamic and allocative efficiency for the same reasons. Decisions by Transpower have the potential to materially affect generation decisions. Distributed generation can substitute for transmission services but we understand Transpower contracts exclusively with line companies to the disadvantage of small generators. Grid constraints appear to be causing unjustifiable price differentials at nodes that are geographically closely located. We consider that these are issues that should be examined in the review.

2.17 ***Other forms of government regulation*** The previous government's separation of lines from energy is now widely condemned. It was not supported by a competent regulatory impact analysis, as required at the time by Cabinet Office Circular CO(98)20. We criticised it as an uncompensated regulatory taking whose likely effect would be to reduce private sector willingness to invest in New Zealand network industries. The enormous industry restructuring forced by this 'heavy-handed' regulation contributed to the subsequent problems of inadequate customer service and the difficulties for companies of balancing supply and customer demand. There are important efficiency reasons for vertical integration in the electricity industry. The electricity review conducted last year by the Hon David Caygill recommended some relaxation of the prohibition on generators owning line companies. An issue for the current review should be whether greater integration should be permitted, subject to normal competition law.

2.18 The use of ODV (optimised deprival values) as a *de facto* form of price control in the electricity industry is another regulatory concern. Rate of return regulation can easily result in cost-plus behaviour (a loss of productive efficiency). To the extent that it has the effect of letting losses lie with the producer while capping profits to the required rate of return, it can be expected to deter investment in future production.

2.19 Environmental regulation already represents a serious threat to future private investment in generating capacity. The delays in getting consents under the Resource Management Act obviously reduce flexibility in the industry and deter investment. The overriding of the common law definitions of an interested party and of a harm has created a 'tragedy of the anti-commons' situation.[1] Side-effects include competitors using the Act for anti-competitive purposes and extortionate demands from opportunistic objectors with no common law interest. The review should look closely at features of the RMA which pose risks to the timely introduction of new generating capacity.

2.20 ***The wholesale market*** Some experienced industry observers have suggested that current wholesale market arrangements are imperfect. In particular, Lincoln Gould has argued that while the wholesale spot market is relatively efficient, there is no adequate market for trading future risk.[2] Regulatory powers relating to price relativities between urban and rural networks and the limits on fixed charges further constrain the ability of retailers to manage risk. These difficulties are arguably holding back demand-side management practices, including the spread of time-of-use metering. Gould has proposed that the best approach here would be to allow retailers to contract and spread their risks in any commercial way they wish. This includes integrating their operations with line companies. We believe these ideas should be examined in the review.

3 Lessons to be drawn

1 James Buchanan and Yong Yoon, 'Symmetric Tragedies: Commons and Anticommons', *Journal of Law and Economics*, Vol XLIII, April 1998.

3.1 The current renationalisation of the electricity sector, if taken to its logical conclusion, would be likely to return New Zealand to the historical situation of periods of under-supply and brown-outs followed by fast-track environmental legislation to allow new capacity to be built. This would lead to periods of over-supply and the equivalent of 'think-big' schemes to remove embarrassing surpluses. Prices to customers would be politicised and, based on past experience, would involve significant hidden cross-subsidies.

3.2 The previous government created a hostile environment for private sector participation, as evidenced by Trans Alta's withdrawal from the market. The environment is now more hostile, with no end in sight to the potential for further regulatory interventions and uncompensated regulatory takings. We believe that it is not being unduly alarmist to suggest that the risks of a California-style electricity crisis in New Zealand will continue to rise.

3.3 This is not a simple matter of blaming government. There has been relentless pressure on governments from self-interested user groups and competitors with relatively little to lose to regulate network industries. Their arguments should be regarded as suspect. Pressures from environmental groups for more regulation should be treated with scepticism.

3.4 Too many commentators simply assume that regulation must do more good than harm if a market cannot be as perfect as in the textbook case. One energy consultant writing in *The Independent* recently asserted that "New Zealand is too small for a fully competitive wholesale electricity market" and argued this was a ground for further regulation.[3] His analysis assumed the existence and efficacy of complex and well-informed analysis by 'impartial' experts. If such omniscient beings existed New Zealand would not need markets. Unfortunately, the reality of problems of information, factional interests and the potential for the misuse of regulatory powers cannot be assumed away.

3.5 With the government being involved so extensively in the industry it is hard to see that it will be able to resist the current drift to ever-heavier regulation and greater state ownership and control. We consider that the review will serve little

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2 Lincoln Gould, 'Distorted Structure Makes More Power Crises Inevitable', *The Independent*, 15 August 2001.

3 John Noble, 'Electricity Problem: Drought or a Dearth of Ideas', *The Independent*, 29 August 2001.

purpose if this issue is not confronted squarely. The government should have the benefit of rigorous advice that is free from presumed political constraints. It should not set its face on ideological grounds against conclusions that the state domination of the industry should be reduced. Any changes to regulation should meet the tests laid down in the Regulatory Impact Statement procedures.