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"Power market just a puppet show"

Article by
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Like the insoluble layers found in a home-made French dressing after it has been left to stand, the Government's terms of reference for its new Electricity Commission creates a strange emulsion of objectives and functions.

Running to 23 pages, the draft policy statement on electricity governance accommodates a wide range of possible roles and strategies.

At one end of the spectrum, the Government could progressively use its dominant ownership of generation, transmission and retailing, combined with its effective control of the new commission, to draw the industry back to a more traditional public utility regime.

Another possible but less likely outcome is that the commission acts as a benign change-agent, enabling the industry to complete its transition from Government-controlled monopoly to efficient competitive market. This was certainly the Government's intention before the 2003 power crisis. Pete Hodgson has always been a keen supporter of moving to a market.

However, a more probable scenario is that, by accident as much as design, the commission will incrementally become a master puppeteer relying on rules and regulations to pull the strings of mannequin industry players that opt for the easy life of Government-sanctioned cost-plus margins.

This spectrum of possible directions is subtly encoded in the new policy statement.

Living as it is on half a lung, how is New Zealand's embryonic electricity market likely to fare? Prospects over the medium term are not good. In the end, it is likely to be overwhelmed by creeping regulation.

What of the Government's plan to ensure security of supply in years of low hydro inflows? Is it likely to work? Unfortunately, not. Indeed, it may make things worse.

The best step to deal with the risk of a dry winter is to store water over the late summer and autumn. This is achieved by reducing hydro generation and increasing thermal generation from stations at Huntly and New Plymouth.

If they had run at full capacity in the first quarter, hydro storage levels would have been adequate, wholesale power prices would not have spiked so dramatically and the general sense of panic and confusion that pervaded the political landscape would have been avoided.

Addressing this key issue of "hydro firming" would significantly improve security of supply and provide a strong foundation for an efficient market to emerge.

Instead, the Government has set up a new commission and told it to buy new electricity from expensive new backup stations that are to run only if and when wholesale prices rise above 20c a unit. This is four times the current average wholesale price - a level rarely reached during the 2003 crisis.

The plan is unlikely to work as it fails to address the fundamental barriers to the Huntly and New Plymouth thermals securing contracts that require them to run hard in the months leading up to a dry winter.

Perversely, the Government's plan is likely to reduce incentives on hydro generators to contract with the thermal stations. It is also likely to delay wholesale buyers' willingness to commit to contracts necessary to support investment in new normal-year generation.

Somehow, the commission is expected to avoid these risks.

However, it is a no-win paradox. On the one hand, the commission's reserve generation must be "visible" to reduce prices. On the other, it must be "invisible" so as not to distort normal commercial incentives on buyers to purchase long term contracts. This catch 22, which is inherent in the Government's plan, is almost impossible to resolve and highlights the plan's basic weakness.

Huntly was not run at full capacity in autumn 2003 because it did not have customer contracts in place to cover the extra fuel costs.

Why? Many wholesale electricity buyers decided to take a punt on spot prices. As the recent succession of dry years shows, this is high risk.

As for Genesis, its commercial strategy over the autumn is still hard to fathom. Hydro firming contracts with Meridian and dry year contracts with larger consumers are activities with the potential to add considerable economic value to Genesis and its shareholders. Why then did it not capture that value? Some buyers say they were concerned that Genesis and other generators may have inflated their contract offer prices on the back of market power. Whether this claim has any substance is not clear. It may just be an ex-post excuse for poor risk management by Meridian and wholesale buyers.

It is clear, however, that the absence of a transparent and liquid contracts market is a fundamental problem in the electricity system. This has been known for several years, but no real action has been taken. Ironically, the Government has been best placed to make it happen, through its ownership of Meridian, Mighty River Power and Genesis. But now this problem too has been delegated to the new commission. Two other important factors that contributed to this year's power crisis are personality and ego. The electricity industry is highly political. Positions of leadership can carry high prestige and influence. A few of its egos spark at high voltages. This certainly happened this year, often with rather counter-productive effects. Behaviour of this kind is characteristic of long-time monopolies with close ties to the Government. It need not be endemic.

In summary, the Government's plan to ensure security of supply in dry years fails to address these underlying factors. At best, it will be a waste of $200 million. At worst, it may seriously distort how market participants manage new generation investments and price risks. The electricity reforms between 1988 and 1998 were driven by four main goals:

- To ensure that growth in electricity demand is met from the cheapest source.
- To get private investors, not the Government, to fund new power stations.
- To ensure that consumers pay the full costs of power from new stations (including the environmental costs).
- To ensure that new stations are commissioned in response to efficient demand signals from consumers, not ad hoc decisions by politicians.

The Government's new regime makes it considerably less likely these goals will be achieved. They could have been if all the necessary changes had been put in place. Too many key elements were missing. Chief among them was cultural change, the vital ingredient few governments like to lead.

The key risk now is that industry is neither a market nor centrally planned, but pretends to be both. The Government's new structure is a strange hybrid in which boundaries of risk and responsibility are obscure. The outcome is likely to be an increase in waste. Gaming will grow. Electricity prices will rise more than they need to. Investment in new supply is likely to be inefficient. Overall, the economy and the environment will face higher costs. In short, the Major Users' decision to push for Government intervention will prove to be short-sighted.

Our electricity industry stands at a cross-roads and the Government's new signpost has not one but several arrows, each pointing in different directions. The reality, of course, is that all roads in electricity now lead to the Government.

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Note – This article was also published on:

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