The Timaru Herald

31 December 2003

"Industry in limbo"*

By
Tony Baldwin

Like food, clothing, money, phones, roads, water and electronics, electricity is vital for life in a modern economy.

Few of us know or care how it is made, so long as it's cheap, instantly available at the plug, and hassle free.

No big price rises. No large profits. Public ownership. Earnings used to keep the nuts and bolts of the system up to scratch. Any surpluses ploughed back into the local community.

This is how most people want our electricity system to work. So why have Governments been messing with it for the last 15 years?

What seemed like a pretty good system appears to have been made hopelessly complicated and dysfunctional – an electricity 'market'. Proof of its apparent failure came with the 'power crisis' earlier this year – the third since politicians started turning everything upside down in the late 80s.

Now a special Commission is needed to sort out the 'mess'. At least, this is how we have been encouraged to see it.

What's really been going on? And will the new Commission make things better? The short answer is not likely, but let's start at the beginning.

Between 1988 and 1998, the electricity reforms were about changing our system to ensure that power is supplied from the cheapest source. Our track record in this area is not good.

The reform's goals were to reduce waste, avoid harm to the environment and save taxpayers money. Competition where possible was seen as the best way to achieve these goals.

One of the reasons so much waste occurred under the old system was that decisions were made by a tiny group of people. A state-controlled monopoly simply can't see all the issues or the different ways of solving them.

* This is the title Tony gave to this article

Good risk management needs lots of independent people sizing up the risks and working out what solution works best for them.

So what went wrong with the reforms?

After 100 years of the Government managing the system, people didn't see why they should be responsible for risk like running out of power or rising prices.

The Government faced a similar dilemma with earthquake risks. For years, the Government has been the insurer. But their policy has changed. Now we are constantly told to manage our own risks. "Fix. Fasten. Forget" – you know the TV ads.

In the case of electricity, big power users should have been encouraged to cover their exposure to hydro shortage risks. In addition, the Government-owned generators should have been offering 'insurance' contracts.

Another key mistake was that electricity buyers have not been able to readily see expected future power prices. By comparison, it's very easy to find out interest rates for the next 1, 2, 5 and 10 years.

This missing mechanism is important. Big power buyers have not been sure whether to get contracts that 'fix' electricity prices, or to keep buying power at 'floating' prices (which fluctuate with changes in expected hydro lake levels).

This is very similar to the choice we make as consumers between a 'fixed' or 'floating' interest rate on our mortgage, except that in electricity it involves a lot more money for big power users.

The reforms also stumbled because some generators got too much control over power prices at certain times. Big power buyers therefore feared they are being ripped off.

This problem would have been reduced significantly if the old Electricity Corporation had been broken into five bits instead of three. Competition would have been much stronger, giving a lot more confidence in prices without compromising security of supply.

Ordinary consumers would also have been better off if the Government had said 'no' to its generators buying so much of the retail sector so early. It weakened the transition to effective competition. Poor performance among some generators in running retail businesses also eroded public confidence.

A final key omission relates to energy efficiency. Particularly in times of a hydro shortage, getting more from less power is extremely cost-effective. It's a lot cheaper than burning gas and diesel at rarely used power stations. Energy efficiency has not been properly developed as a source of new power.

Ministers say we look Third World if we have to trim our power use in a dry year. They say we therefore need to build more expensive back-up stations that will stand idle most of the time. This is wonky logic. Using energy more efficiently when it's cheaper is not Third World – it's smart economics. The Government's recent announcements suggest some change of thinking.

It was always going to be a major challenge to transition from a 100 year old state monopoly to an efficient market. It's like asking a group of people to move across a high suspension bridge when most in the group are scared of heights. To make it even harder, imagine that the bridge is still under construction as people walk across it. Many simply refuse to start. Others take fright mid-way and don't know whether to go forward or back.

Will the new Electricity Commission finish the bridge or tear it down? It is not clear. The industry is in a bind. It is neither an efficient market nor a well-run public utility.

Will the Government's new plan to avoid power shortages work? Probably not. For a variety of reasons, it could actually make matters worse.

Cheap hydro power gives our economy a competitive edge. But it comes with risks. Most of the time, we get enough water flowing into the hydro lakes. The trick is to respond efficiently when we don't.

Many low cost solutions are available. Unfortunately, the Government's proposal is likely to waste money and cause electricity prices to rise unnecessarily.

Tony Baldwin
Chair of the Officials Group advising Government on Energy Reforms
1991-98