Energy in WA Conference 2013

"Walking the Tightrope – Balancing the interests of customers and energy market participants"

Pan Pacific Hotel, 21-22 August, 2013

Introduction:

- Thanks for the opportunity and my appreciation and congratulations to the AIE and the PUO for again organizing the best energy conference in WA.
- I have a limited 10 minutes to express a view and hopefully stimulate some questions and discussion

The Topic is wrong headed!

- Can I start by taking issue with the topic – it is a false proposition and wrongheaded (and Peter Kolf, who is responsible for organizing this session, should know better!)
- It should not be a question about balancing the interests of customers against the interests of other participants but rather it should be about maximizing the long term interests of customers
- Adam Smith probably said it best more than 230 years ago – "*Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer"*
- Apart from customers or consumers, when we think of energy market participants we think of retailers, distributers, producers, regulators (economic, safety and environment), market operators, governments (unfortunately) and the various suppliers to these participants (such as those represented on the panel by Greg – that is, consultants (and I will resist the urge to say unfortunately – some suppliers are necessary!)) I will comment on government as a participant later.
- As Smith points out it should not be a matter of balancing these various participants' interests but of ensuring that they act in the interests of maximizing the benefits to customers.
- I need to hasten to add that this is about the long term interests of consumers – it is not about an economic regulator of the monopoly aspects of the energy market setting a rate of return so low (to keep current prices low) that there is no investment in the future (or vice versa) or a safety regulator setting such high standards that energy becomes unaffordable (or so low that consumers lives are at risk) – there are issues (rather than interests) to be balanced here but again the test here is what is in the long term interests of consumers.

The World of Second Best!

- It is generally accepted that the interests of consumers are likely to be maximized by having competitive markets, provided all costs and benefits are captured in the market outcomes.

- However, this is not always the case and it is this lack of competition or the presence of external costs or benefits that creates the necessary (but not sufficient) justification for regulatory intervention – the presence of monopoly power for economic regulation and the presence of externalities for safety or environmental regulation.
- I stress the “necessary but not sufficient” justification. Regulatory intervention is only justified if there is market failure **and** the regulatory intervention leads to a superior outcome (in the long term interests of consumers) **and** the benefits of the intervention exceeds the costs. I am sure I don’t need to remind this audience that regulatory failure can be at least as common as market failure and some say it comes with a potentially much higher cost!
- Regulation is very much in the area of second best – economic regulation is trying to second guess what a competitive market would do – similarly safety and environmental regulators are inevitably trying to second guess consumer preferences as there is no direct measure of the trade-offs society is willing to make. These are administered decisions not the result of the voluntary interactions of buyers and sellers in a market place. It is not an exact science – an obvious fact but not one always at the front of the debate.

The Challenges for Economic Regulators

- I have said it is not about balancing the interests of consumers against other energy market participants but I have also said that there are issues to be balanced and so now I would likely to briefly focus on two of the challenges facing an economic regulator in balancing those issues – information asymmetry and getting the incentives right.
- When regulating providers of infrastructure, regulators – economic, safety or environmental – are always going to be at a disadvantage – the provider will always have more information than the regulator. Almost no matter how much time and effort (and therefore cost) the regulator puts into assessing particular issues, the regulator will never have the same understanding of the business as the provider. There is a balance here about just how much information is needed and at what cost (both to the provider and to the regulator – particularly when ultimately all costs will be borne by consumers – as either consumers of the particular service or as taxpayers). There is also a need to balance the need for more information against the need for timely decisions.
- For example, an economic regulator needs enough information to be confident that an access arrangement proposal for monopoly infrastructure is reasonable by giving the provider an appropriate return on its investment and the consumer a quality product at an affordable price. But not more – it is not the role of the regulator to step into the shoes of management and second guess every potential investment or expenditure. (I have to say that sometimes I am not sure that Treasury understands the distinction when thinking about the ERA’s role with respect to GBE’s). In making this assessment of just how much information the regulator needs the openness of the provider in the past can have an influence and I am sure this is just as true for environmental and safety regulators.

- In response to this challenge we have incentive regulation to try and encourage the provider to be as efficient as possible. This is probably the biggest challenge facing any regulator – how do we create incentives that will encourage the provider to maximize the long term interests of consumers. Any regulator (economic, safety or environmental) I am sure will be able to provide you with examples of perverse incentives. Indeed, this problem of perverse incentives is everywhere (see three year elections and the current election campaign!) I am quite confident that Allan could provide a lengthy discussion on the challenges faced by the IMO in ensuring that the market rules (and particularly changes to the market rules) do not create perverse incentives that are not in the long term interests of consumers.

Government as a participant in the market

- Let me refer briefly to one other challenge in balancing issues – the role of the government as an energy market participant. This could be a lengthy topic in its own right but I just want to highlight a couple of issues. It is a problem in WA and we are all aware of the conflicts of interest when the government is both policy maker and the shareholder of major (or even minor) market participants.
- Government involvement in the market can create confusion or doubts among market participants about government's overall objective in the market or the reasons for policy changes. For example, there has been a debate (including by the ERA) about who should be leading the reform process in the Wholesale Electricity Market and while we have argued it should be lead by the PUO (with wide and transparent consultation) it cannot fulfill that role without being seen to have a conflict of interest – it is at risk of been seen to be trying to balance the interests of consumers with the interests of the shareholder. Or, as a more current example, the debate about the reasons for the merger of Synergy and Verve.
- Perhaps finally, a not quite so obvious example of the problem. When the ERA delivered its final decision on Western Power in late 2012, the then Minister for Energy issued a directive to Western Power not to appeal the decision. One can surmise that with power prices a politically charged issue and with an election coming, the government was not keen to be seen appealing a decision of the independent regulator that would, if successful, lead to higher prices. Personally, I was disappointed by that directive and believe the decision to appeal or not should have rested with Western Power. While I was, and still am, confident that the decision would have stood up under an appeal, if Western Power had a view that the ERA was in error in the decision then that should be tested.

Transparency

- They say that one of the best disinfectants is sunlight. Likewise transparency is necessary for healthy markets.
- While different people may have different views about the success or otherwise of the opening up of the electricity market in WA, one thing I think we could all agree on is that there has been increased transparency and that is unambiguously a good thing.

- Referring back to the comments I have just made, transparency would be increased if the government was not an active participant in the market. I for one am concerned that the current proposal to merge Synergy and Verve will reduce transparency.
- If we want to maximize the long term interests of consumers then one of the most important issues we need to address is the need for transparency in any market.

Conclusion

- I am rapidly running out of time so let me conclude.
- Regulators are “walking a tight rope” but it is not about balancing the interests of consumers and energy market participants, it is about balancing issues to make sure that the behavior of market participants is consistent with the long term interests of consumers.
- I am glad that this presentation is relatively early in the Conference as I have a suggestion (which perhaps you can also apply retrospectively). As you listen to the presentations of the various speakers representing various market participant interests, ask yourself is what they are saying or suggesting in the long term interests of consumers.
- Thank you.