“Role of Government in the Energy Sector”

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Introduction

Thank you to CEDA for the opportunity to participate in this important discussion and to start the discussion and perhaps even establish some principles with respect to the role of government in the energy industry.

In the brief time I have available I want to do a number of things – set the scene, look at potential roles for government and any conflicts of interest that arise, look at an ideal industry structure and the government’s role within that structure and then make some concluding remarks.

Set the scene

I thought I would start with this overhead:

> *Government – If you think the problems we create are bad, just wait until you see our solutions!”*

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

However, this is not always the case and it is the lack of competition or the presence of external costs or benefits that creates the necessary (but not sufficient) justification for government or regulatory intervention in the market.

I stress the “necessary but not sufficient” justification. Intervention is only justified if there is market failure **and** the intervention leads to a superior outcome (in the long term interests of consumers) **and** the benefits of the intervention exceed the costs. Both government and regulatory failure can be at least as common as market failure and some say it comes with a potentially much higher cost!

In addition, as the theory of public choice makes clear, the motivation of the interveners is not always the long term interests of consumers, making the risk of the failure from market intervention even greater (at least from the perspective of consumers).

I raise this at the start because often there is a tendency to look to government intervention in one form or another at the first sign of market failure ignoring the perhaps greater risk of government or regulatory failure.

Despite the presence of both market and regulatory failure, history, in my view, is on the side of those who argue that the allocation of resources by markets is to be preferred to the allocation of resources by governments if the objective is to maximize the long term interest of consumers.

There is one other scene setting issue I want to discuss. In a talk to the Institute of Engineers last year on the electricity market in WA I made the following comments:

In speaking to a room full of engineers I said there may have been some sympathy for the following view:

> "Electricity is a complicated business (for example, it requires that supply exactly matches demand in real time), it is important infrastructure that needs to be planned, it is a vital service, all of which leads to the view that it should be centrally planned and controlled – a government owned vertically integrated monopoly is needed to deal with such a complicated business"

I suspect there may be some in this room who would sympathise with this view!

Although it may be counter-intuitive, I argued then exactly the opposite. This is explained more elegantly than I can by F.A. Hayek in his 1944 book "The Road to Serfdom". Hayek explains:

> "There would be no difficulty about efficient control or planning were conditions so simple that a single person or board could effectively survey all the relevant facts. It is only as the factors which have to be taken into account become so numerous that it is impossible to gain a synoptic view of them, that decentralisation becomes imperative. But once decentralisation is necessary, the problem of co-ordination arises, a co-ordination which leaves the separate agencies free to adjust their activities to the facts which only they can know, and yet brings about a mutual adjustment of their respective plans…..This is precisely what the price system does under competition, and which no other system even promises to accomplish…..It is no exaggeration to say that if we had had to rely on conscious central planning for the growth of our industrial system, it would never have reached the degree of differentiation, complexity, and flexibility it has obtained. Compared with this method (competition)….the more obvious method of central direction is incredibly clumsy, primitive and limited in scope."

In the same book Hayek also has some wise words with respect to state monopolies which I can't help but repeat:

> "…. a state monopoly is always a state-protected monopoly – protected against both potential competition and effective criticism."

Monopolies are not just inflexible and lack transparency, they can also be slow to adapt and innovate – in economist speak, they lack dynamic efficiency. And yet, it is dynamic efficiency that is likely to be very important for the future of the energy industry. For example, with the advent of embedded generation (of various forms) and a possible competitive solution to the energy storage challenge, then the old system with its strong focus on poles and wires may well be challenged. Consumer interests will best be served by an environment that encourages innovation not one that locks in existing structures.

My starting point then is that transparent, competitive markets where possible are preferable, including in the energy industry.

Roles of Government in the Energy Sector

While there are many different roles the government can play, those roles can be summarised under two headings – government as regulator/policy maker or government as market participant/player.

These dual roles are a problem in WA and we are all aware of the conflicts of interest that arise when the government is both policy maker and the shareholder of market participants. I want to look at this from four different angles.

Policy maker vs market player

Government involvement in the market can create confusion or doubts among market participants about the 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 Public Utilities Office (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, another example of this conflict is the confusion and debate about the reasons for the merger of Synergy and Verve.

Price setter vs shareholder

The example I will use here relates to Water Corporation. In January this year the ERA published its report into Water Corporation and recommended tariffs for the next three years. The tariffs recommended would have enabled Water Corporation to fully recover its efficient costs including an appropriate return on capital. Combining water and sewerage charges, the recommendation for the average household in 2013-14 was a reduction in tariffs of 8.2% or $100. The tariffs that were set by the government were an increase of 6% or around $80. For the average household an additional cost of $180. The conflict between the government's role as a price setter (ideally in the interests of consumers) and its role as a shareholder is obvious.

Political issues vs shareholder

A perhaps less obvious example. 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.

Representing consumers/citizens vs market player

We elect governments to make decisions on behalf of us all. In making those decisions the government's focus should be on the long term interests of the citizens. I referred earlier to the theory of public choice but the challenges of good government are even further compounded if government itself is seen to have a direct commercial interest. At best there will be a perception of conflict, and at worse, actual conflict. There is a national debate about the role of consumers in economic regulation and how do we ensure that the consumer voice is heard. For example, how do we determine what service standards and level of security consumers want, or more importantly, what they are willing to pay for? Perhaps it is because governments are seen to have conflicts of interest that there is such considerable debate and effort being put into trying to find other ways of ensuring the consumer voice is being heard rather than accepting that this is a legitimate role for our elected representatives.

The Ideal Role for Government

Markets are most likely to operate in the interests of consumers when they are competitive and when the policy maker, who sets the policy environment under which the market operates, is independent of the market and not a vested interest. So where competitive markets are possible, the government's role should be limited to addressing any market failures (subject to the qualifications I made earlier, particularly ensuring that any such intervention does actually result in better outcomes and does not have any unintended consequences). Otherwise, set a competitive policy framework and then leave the market alone and therefore minimize sovereign risk and maximize certainty.

Where markets are not competitive, for example, infrastructure natural monopolies (gas pipelines and electricity poles and wires), then government's role should be to establish an independent regulator to deal with issues such as third party access. Even if the government is not a participant in the market, independent regulation is still essential to ensure decisions are, and are seen to be, independent of any political considerations, again minimizing sovereign risk and maximizing certainty. As discussed earlier there may be a role here for the government to step into the shoes of consumers to set things such as service standards or security of supply requirements, but it can only do this effectively when it is not seen to have a vested interest in the outcome.

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. 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. Referring back to the comments I have just made, transparency would be increased if the government was not an active participant in the market. For similar reasons, I for one am concerned that the current proposal to merge Synergy and Verve will reduce transparency.

Where there is market failure leading to a lack of transparency, this becomes an important potential issue for the government to address.

Conclusion

I am running out of time and so let me bring this to a conclusion. While in my preferred situation there is a role for government in the energy sector, in my view it is a limited role and it should be one that avoids conflicts of interest (real or perceived).

It is also clear that the Western Australian energy sector is some way from the preferred position I have outlined. I don't have time, and it was not my role in this presentation, to suggest how we might move to the preferred position. However, I think it is fair to say that we are in a position consistent with the tourist asking the Irish man about directions to a new destination. His reply: "If I was you, I wouldn't start from here". There are challenges in the WA energy sector.

I had the privilege of listening to the Minister's speech at the Energy in WA Conference two weeks ago. Perhaps we hear what we want to hear, but I thought what Minister Nahan said then was not necessarily inconsistent with the comments I have just made. Given our current position there is clearly a role for the government, not least to help transition to a more preferred structure. I look forward to the Minister's presentation today.

Thanks for listening.