

The Importance of Energy to New Zealand Business

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There is no doubt that energy has been and will always be important to New Zealand business. However depending on where you are placed in the economy and to what extent you are reliant on a secure, sustainable and fair price for the energy you rely on, determines your level of interest in government policy or market activity at any given time.

Many of us will remember the global oil shock in 1979 when government announced rationing of oil supply and institutions and organisations began looking for ways to maintain the same level of production with 20% less oil. This was the beginning of the energy efficiency industry but it was also the beginning of 'Think Big' as the government of the day strived to make New Zealand as self sufficient as possible. There was oil and gas exploration resulting in Maui, the Urea plant and the Methanol plant and the biggest and best of all the Clyde Dam.

Moving into the 80's we once again had readily available oil at a realistic price, we had our own natural gas supply, we had adequate generation to meet our known future needs, even though the Clyde project had well exceeded budget and was producing the most expensive electricity in the country. Previous hydro schemes produced electricity at around 20 cents/kWh and sold it at 2 cents/kWh while Clyde was far in excess of that.

These were the halcyon days when government made energy sector investment decisions on behalf of business and attempted to meet our every future need regardless of cost, while maintaining the retail price at internationally competitive rates by absorbing the sunk costs of infrastructure. This together with a think big mentality encouraged energy intensive industries to flourish giving a much-needed diversification from our agricultural base economy. It was this approach that ultimately led the same government some 10 years later to look at shedding any further responsibility for the timely provision of electricity supply.

This was to be achieved by splitting Transpower out of ECNZ and making it a stand-alone profit driven organisation rather than a public good service provider. In addition ECNZ was split in two and Contact, the smaller part privatised by accepting a cornerstone shareholder (Edison Mission) with the balance of shares available to the New Zealand public. The float price was \$3.10/share and judging by the latest quoted price for the few remaining public shares the company has done rather well in its transition from government to Edison mission to Origin Energy ownership.

This minimal adjustment to the generation sector proved insufficient to provide true competition so ECNZ was further split into Meridian, Mighty River and Genesis. These 3 companies were also set up under the SOE model whereby they are

required to make a realistic profit. A change in government at the end of the 90's ensured there would be no further privatisation.

Prior to the change in government there was further concern with market power and potential cross subsidisation so the local energy companies were broken up into line and energy businesses and a timeframe set for complete ownership and management separation.

New Zealand business welcomed this approach as markets have long been recognised as the optimum mechanism for delivering goods and services at the least cost.

There was however an unexpected outcome from this enforced separation whereby the generating companies began to buy the retail customers from the local energy companies and thus formed vertically integrated generation and retail companies. There was no further intervention.

By now we were approaching the late 90's and proudly led the world with our market orientated electricity sector. Although the original government intent was to shed the responsibility for timely investment in electricity infrastructure they had ended up owning more of the industry than when they started. The difference now was the user paid not the taxpayer and the market decided when new investment would occur not a central planner.

Around this time business began to notice that the wholesale price of electricity was steadily rising and the secure contracts available in the past were now more difficult to obtain and certainly were more expensive.

Our supply and demand gap was closing, our national transmission system was becoming more constrained after 50 years with little or no investment and in true market fashion there would be no further investment in transmission or generation infrastructure until the price signal indicated it would be profitable to invest. When 1:60 dry year events began to occur every second year we did not see a reduction in available electricity in the same way we did with oil in 1979 but instead we saw a dramatic increase in the spot price of electricity. Unfortunately only 30% of the market was impacted by the price and of these energy intensive businesses less than 20% of their consumption was impacted.

When energy is over 15% of the input to your business and you have had 10 years of steadily rising prices you become as energy efficient as you can. It is now widely recognised that our energy intensive sector are within 3% of world best practice and so the opportunity to reduce further the consumption levels of 30% of our market is small indeed. The impact therefore is lost production and consequent lost income for New Zealand Inc.

We therefore have an electricity market that delivers short term pricing signals that have no impact on 70% of consumers but does not deliver long-term price signals that encourage further investment.

The oil market on the other hand delivers short term pricing signals to all consumers but in recent times has demonstrated that you require a 200% increase in price to influence around 7% of consumers to reduce their consumption.

Adding to the problem our independent natural gas supply is reaching the end of its useful life and the alternative of imported LNG is looking extremely expensive.

In addition to the supply/demand and pricing issues we also face the spectre of meeting Kyoto targets for greenhouse gas emissions that when originally agreed to were assessed as providing a \$500 million windfall gain but now are looking ever more like a multi billion loss. Now whether you believe that the science has proved beyond all doubt that we have a serious global problem or whether you are still unconvinced the problem is man made the fact remains that our government is committed to meeting their agreed Kyoto targets even if that has a negative impact on business. Not only that but they have exempted around 80% of the causers and are focussed on business and electricity generation (aggregate 16%) as the areas requiring potentially punitive action.

Progressive attempts to ensure that the electricity sector functions like a real market has resulted in the establishment of the Electricity Commission – a body responsible only to the Minister of Energy for the performance of the market including transmission. In addition the commerce Commission is responsible for ensuring that monopoly businesses do not abuse their position. As can be seen from recent events the result of double regulation is total uncertainty but even more concerning we seem to be returning to central planning within a free market structure.

I began by saying that energy had and always will be important to New Zealand business. I would add however that even more important is an environment that delivers certainty. Business in New Zealand cannot survive in a vacuum where there is no certainty that timely investment will be made in energy infrastructure or that New Zealand will, if not offering the price advantages of the 80's at least offer a level playing field with its pacific rim competitors most of whom have no commitments to Kyoto are relatively self sufficient in energy resources and have significantly lower electricity prices than New Zealand.

So we know how we got to this point, the big question is - "Where to from here?"

Accepting that energy is extremely important to the future of business and therefore the future growth potential of New Zealand what would we do if we had a clean sheet and what is the desired outcome. Let's take today as ground zero and move forward from here. We have a large and growing agricultural industry the mainstay being dairy products. We have a number of energy intensive industries that are internationally competitive. We have a thriving service industry. We have a growing film industry and an expanding wine industry. We have a multitude of small and medium sized enterprises across all sectors.

To maintain business activity at the present level we need a guaranteed supply of energy at competitive international price. To look to grow the economy at the desired rate of 4% p.a. we need to have certainty that the supply of energy required to meet this growth will continue to be available at a competitive international price. Without

this level of certainty we will not see the growth and development we require to maintain our standard of living.

Back to our blank canvas.

We have a number of electricity generators located around the country and in the main close to their fuel source, as that is usually the most economic way to generate. This requires a reliable grid to interconnect the generators and the points of load, which in the main are not located in close proximity. We need readily available gas and oil supplies and like electricity we need a reliable transmission system to convey the fuel to the main areas of use. At this point in time we have all of the requirements to maintain the status quo. However we need to plan for the future and that is where there is divergence. There is nothing wrong with divergence but in the end someone needs to make the decision and take responsibility for it. That is where we begin to come unstuck and where some of our systems and processes are exacerbating rather than solving the problem.

Let's take electricity transmission as the first example since it is a fairly topical issue and greatly discussed in the media and consequently there are as many opinions as there are people. We have a government owned company responsible for maintaining and enhancing the national grid to meet the growing needs of the economy. They are fully resourced and we assume qualified to undertake this role. Or it least they appear to have been up till now. This SOE has at least three Ministers to answer to for its commercial performance, two SOE Ministers (acting as shareholders on behalf of all New Zealanders) and the Minister of Energy who monitors its behaviour and professional performance on behalf of all New Zealanders. In addition, because it is considered a natural monopoly, although in some instances it is a statutory monopoly, it is answerable to the Commerce Commission with respect to its revenue and general commercial behaviour. The Commerce Commission is a totally independent body and has no responsibility directly to government or specific Ministers as the main part of its reason for being is ensuring all companies behave in a proper manner and that they do not gain monopoly status by merger or acquisition.

This transmission SOE is also beholding to the Electricity Commission with respect to the technical competence of its proposed investments, its pricing methodology and the form and content of its customer contracts. In a separate role it carries out the duties of system operator under contract to the Electricity Commission. The Electricity Commission is generally an autonomous body responsible only to the Minister of Energy but generally has Carte blanche when implementing the Government Policy statement on electricity. It is not surprising that we have been witnessing a series of Mexican stand-offs of late between the transmission SOE and its regulators. However neither the shareholders nor the Minister responsible for performance are prepared to intervene. So what we have is total uncertainty for business where they are impacted by the positions of the various parties. It is unlikely in this environment that we will see any significant investment by business and it is likely therefore that we will not achieve the desired economic growth rate to sustain our standard of living.

But it is not just business that faces uncertainty. The landowners over which the proposed new lines were to travel are faced with a delay of at least three years after which the then management of the transmission SOE may review the route or any other factor in which case we start all over again. While this continues and looks to spread to other proposed upgrades we are unlikely to see generators commit to further investment. All up we have an environment that discourages investment and growth while the Govt calls for businesses to look ahead and achieve a 4% growth target.

There is no greater sense of security with other energy sources. We are told that our gas fields are running out. Apparently the world has reached Peak Oil and we will eventually run out of oil. We are being asked to accept that New Zealand will need to consume less energy while producing more export goods and that the energy we do consume needs to come from renewable sources.

No one wants to kill the planet. We need to find a way of transitioning in a rational way. We cannot be expected to meet arbitrary targets for greenhouse gas emissions without the technology to assist. We need to ensure that our infrastructures grow ahead of our requirements not just in time.

It may make pure economic sense to operate that way but it's a bit like calculating how far you are going to fly that day and only putting on board enough fuel to meet your calculated consumption regardless of potential weather problems, delays at airports change in loadings and the likes. It might work once or twice but eventually you will crash.

At the moment we seem to be looking for a miracle cure. We all accept that long term planning in our political environment requires cross party agreement on policy framework at least. That is one of the two big positive opportunities that exist in this otherwise depressing debate. The opportunity to create real long term cross party support for what needs to be done. Business would welcome that very much because it would give the best opportunity to make good investment decisions and to encourage investment.

The second big opportunity relates to the opportunity of putting business front and square in the climate debate. We have been in the trenches business and Government on this matter for too long. We need to step back and look at what will really work to allow business to contribute to a good Kyoto outcome but at the same time ensure a good climate for growth.

If we continue down the current path of muddled thinking, ever changing policy, multiple regulators in a market environment business owners in New Zealand are going to be looking for the energy to get out of bed in the morning, never mind a secure and sustainable energy supply for their business.