Privatisation of Victorian Gas and Electricity Industries: Did we Get Where we Thought we Were Going?

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SUMMARY

This paper examines the four main objectives the reforms set out to achieve. First the improvement of power sector efficiency, secondly the empowerment and benefit of customers, thirdly, reduction of State debt and improvement in the State’s budget position with the transfer of risk away from taxpayers and, finally, the enhancement of power sector contribution to the State economy. There were several subsidiary objectives which, if they could be achieved, would be an added bonus.

In assessing energy reform in the light of the various objectives the paper concludes that Victoria is a world leader in energy reform as it is recognised as having set the international benchmark in this area.

Although the energy market in Victoria is not without some problems, the problems are far less than those of other markets and are widely shared. It is not reasonable to expect that the market will operate perfectly all the time. However Victoria’s market is intensely competitive and market signals are working well. Both government and taxpayers have enjoyed direct financial and service benefits from the reform process while the outcomes are mixed for investors and industry operators.

The regulatory regime has worked well overall however, regulators have tended to see their role as being to shift virtually all benefit to consumers and this combined with an excessively mathematical and rigid approach from regulators is a potential major adverse influence on value and new investment in regulated assets. Business has used competition and benefited but while households have made price and service gains they still need choice of supplier.

The paper concludes that energy is more efficient and the gains are sustainable.

BACKGROUND: ENERGY IN VICTORIA

Energy is a key comparative advantage for Australia and particularly for Victoria, but the State had suffered from having one of the most highly vertically integrated Government-owned energy industries in the world. Victoria had an energy industry that had been marked by very poor investment, by low operating efficiency and by low power station availability. It had little customer focus at the retail end and its performance was not only bad, but was deteriorating. Particularly through the 1980s and the very early 1990s Victoria had slipped from being Australia's low cost energy provider to being third behind Queensland and New South Wales.

The State Electricity Commission of Victoria (SECV) had great political power and that was exercised, for example, in building new coal-fired power stations "toys for engineers" against the background of a State whose public finances were in a state of crisis.

REFORM OBJECTIVES

In 1992, the new Government came to office with a whole series of objectives. The four main objectives were to:

- improve efficiency, both in terms of investment practices and in terms of operational efficiency;
- empower and benefit customers to ensure that they got the benefit of the improved performance;
- reduce the State’s debt, improve the State’s overall budgetary position so that it could help to reduce taxes and increase spending on services, and particularly, and something that’s often overlooked, to transfer risk away from taxpayers; and
- enhance the power sector's contribution to the overall performance of the State economy.

The Government had a series of subsidiary objectives to:

- broaden community shareholding;
- promote employee participation;
- improve labour relations;
• foster a listed utility sector;
• achieve environmental benefits.

These objectives were subsidiary in the sense that the four main considerations drove the process, but the subsidiary objectives were to be achieved where circumstances permitted.

Finally, an overall objective was to produce an integrated energy industry involving both gas and electricity and for that matter, other energy sources, to ensure that we optimised the use of the State’s resources across the whole energy sector, not just within the electricity or gas industry standing alone.

REFORM OUTCOMES

There is no one single answer as to whether the reforms took Victoria where we intended to go. We need to look at the outcome in terms of different stakeholders. Relevant assessments include looking at Victoria as a world leader in reform in this area; to look at whether the market works; to look at the outcome for government and taxpayers; investors and industry operators; the regulators and regulation; to look at the consumers, first industrial and commercial consumers then residential consumers and then look at outcomes in terms of industry efficiency.

Have the reforms actually increased the efficiency of the use of the resources the State has invested in these major sectors?

Victoria: A World Reform Leader

The reform process has had a very positive outcome for Victoria. Most would agree that as we all travel around the world there is enormous recognition of the reforms undertaken in Victoria and a very widespread view that they are amongst the best, if not the best example of how to introduce a competitive market into the electricity and gas sector. They are regarded as an international benchmark, not only in terms of the outcome, the competitive market, the sustainable and viable market that has been created, but also in terms of the way the reform process was managed and in the way the privatisations were managed as commercial transactions. That has attracted attention to Victoria in many, many countries, particularly at the government level. The man in the street in, say, Thailand might not know much about energy reform anywhere, but amongst opinion
leaders in industry and government, there is in fact some knowledge that Victoria basically got it right.

The success of the reform process has resulted in many Australian consultants gaining extensive advisory work around the world, as far afield as Czechoslovakia, South Africa but most particularly across Asia. There is no doubt that the reform outcomes have certainly helped to put Victoria on the map. I do not want to overstate this point for such recognition is largely confined to government and the industry itself but certainly, Victoria is regarded as a world leader in the field.

In addition, the reform outcomes have helped to make Victoria’s economy more adaptive and competitive and again, there is also recognition of that around the world.

**New Market Performance**

It is important to note that, when undertaking reform of an industry sector as significant, as big, as diverse and as complex as this one, there are bound to be some things that go wrong; the market does not work perfectly. Indeed markets do not work perfectly anywhere. The test is not, “is the market perfect?” the test is, “is it better than the alternative?”

It is not common for energy markets to work perfectly anywhere in the countries which have undertaken reform. In terms of effectiveness they vary from Victoria and the United Kingdom (probably at the success end), through to places like California and some of the Asian economies which have just begun to embrace reform.

Victoria’s problems are less than in most other reformed jurisdictions, but the types of issues are widely shared. Many of the issues that the Victorian Regulator-General is grappling with, for example, have bedevilled the regulators and the industry in the United Kingdom, which I think is a very close parallel to us and probably with us at the success end of the spectrum. We should not expect the market to produce perfect outcomes all the time and indeed some of the things people describe as market failure, like prices trending upwards, can actually be the market working very well, sending signals for the next major increment of investment required.

Victoria’s market is amongst the most intensively competitive in the world, if not the most intensively competitive, and finally, it is clear that the market signals are working. They are working when
consumers are exercising the available choice where the market has been deregulated in their sector. They were working when the interconnector to New South Wales was upgraded rather than another new huge brown coal-fired power station constructed in Victoria, for the market is good at allocating available investment funds.

The fact that new generation projects, especially peaking capacity, are needed and that a number of projects have recently been announced is a further indication that the market signals are producing responses from investors in the areas where the market needs additional capacity. In addition, of course, new gas projects that have been on the drawing boards for many years are now likely, and I say likely only because we can’t be certain, to be developed in response to the new market structures.

The Stakeholders in Reform

Government and taxpayers

Government and taxpayers have benefited enormously in almost every respect from their involvement in this industry. The privatisation sales yielded (along with other privatisations) around $28 billion, most of that from energy privatisations. The sale proceeds exceeded the book value of the assets very substantially. The electricity assets were amongst the most successful privatisations, selling at 17 to 22 times earnings before interest and tax. That represented a significant net addition to the State’s wealth as verified by the Auditor General.

It is difficult to precisely calculate the net interest saving because the accounting series have changed dramatically over the period of the reforms, but we estimate that something in the order of $1200 million every year in interest is being saved by virtue of the debt reduction and, of course, those savings were available, were used and are still being used to reduce taxes in and to increase spending on services in Victoria.

The State’s net debt in 1992 was $32 billion. In 1999 it was $5 billion and at the end of the last budget year it was actually $4 billion. The fact that that debt has been dramatically reduced means that, were interest rates suddenly to rise, as they did during the 1980s and the early 1990s, Victoria would have a far lower risk of a “blow-out” in its interest bill and, therefore, we would not face again the prospect of having to raise taxes, reduce other service spending or do both together just to pay interest on debt. Victoria’s public finances are now regarded as very secure, a point that not only the Kennett Government made, but one which the current Government is making.
Substantial risk transfer

There has also been a substantial risk transfer from taxpayers and people as consumers of State services to investors in the privatised assets. This is something that is very seldom appreciated and understood by people, but one of the Government’s main motives was actually to reduce the risks taxpayers were facing through owning these very large infrastructure industries. The interest rate risk has been reduced as I just said. The taxpayer risk of owning the assets has been reduced. It might be irrelevant if they are never going to be sold, but the value of the assets is important and two former heads of the New South Wales Treasury produced a report some years ago which suggested that, in the first year of the deregulated national market, the New South Wales taxpayer actually lost $2 billion on the value of their electricity industry assets.

Taxpayers have been freed from the risks of having to fund future investment in the industry.

In the sale process, warranties and indemnities in virtually every sale were capped at $1 so there is no ongoing risk that the State carries in relation to the privatised assets.

Environmental risks are rife in these industries. Contamination through to subsidence from the de-watering programs in the Latrobe Valley for example. Those risks have been transferred to the private sector so the taxpayer no longer bears them.

The political outcome has been one that few people would have expected, and that is, the focus has turned to the industry and away from Ministers. It is much less common now for Ministers to face questioning in the parliament about the day-to-day performance of the energy industries. Rather, the focus of parliamentary attention has tended to turn to broad strategic issues and policy matters which, I think, is where it should be.

Investors and industry operators

The reform outcomes for investors and industry operators have been mixed. We have to acknowledge the fact that there have been some winners and some losers.

The generator companies have faced very low pool prices, much lower on average until very recently, than the prices upon which their acquisitions were predicated and they have lost value. There have been significant write-offs and where the vehicles have been listed, they have crystallised that loss of value. The positive side I guess, for most of us here, as one banker said to me recently, was that one of the great achievements of the Kennett Government was
that it persuaded a group of United States and United Kingdom investors to simply donate $5 billion to the Victorian taxpayer. But from the point of view of the investors, particularly the generation sector, it has not been an unmitigated joy.

For transmission and distribution owners of course, there has been less impact from lower pool prices and indeed, to some extent they have tended to gain, especially in relation to regulated customers. The initial benefits for them were very significant, although more latterly the emergence of what is called regulator risk, has put something of a cloud over regulated assets. There is now a very highly specialised market in regulated assets and they are quite a different investment from general industrial investment. The particularity of these markets appears not to have been fully appreciated at the time people invested in these assets. So it could be said that there is some risk there, and in some cases, there have been significant losses as a result of that change in the attitude towards the market for regulated assets.

In short, regulated assets have come to be regarded as pretty unexciting, as low risk, as attracting a low return and as likely to tend towards a bond type investment, and that of course is not attractive to most equity investors. There has emerged not only an issue of significant regulator risk, but even some concern expressed around Australia, and indeed, to some extent overseas, that this represents the emergence of sovereign risk in Australia.

On the other hand, the other half of the distribution businesses, their retail activities, have become very highly prized. It has been realised that synergies can be captured across a wide range of sectors, not only in gas and electricity, but in things like telecommunications and other “network” industries. Accordingly, we are seeing the integration of these service sectors and the integration of their customer bases. The extraction of synergies from their customer bases has become a very dynamic area of the market.

Regulation and the Regulators

The regulatory regime, has worked very well over all.

We were told when we were planning the reforms that competition by comparison simply did not work – that the industry would not respond to exposure of relative performance. However, instances like the reaction to the regulator’s very first report demonstrated that competition by comparison does work. In this instance, Citipower was highlighted as having a higher incidence of disconnection of customers for failure to pay their bill than the other
companies had. Their reaction was immediately to start a program to explain why they had that higher incidence, and then the adoption of a program to eliminate disconnection as a means of credit control. That development was a manifestation of competition by comparison actually working. It is clear that the regular comparative reports issued by the regulator do have an impact on industry behaviour.

Economic regulation on the other hand, and I here acknowledge a quite legitimate difference of view with John Tamblyn, I do not think has worked as was originally intended.

Regulators have seen their role as being to shift, in my view, more than was originally intended of the benefit – virtually all of the benefit of industry gains – to consumers. The system tends towards an excessively mathematical and rigid approach with too little recognition of the need for commercial judgment and inadequate acknowledgment that the investors in these industries have made commercial judgments as the basis of past investment decisions and will predicate their future investment on commercial judgments. There is a danger of our lapsing, contrary to the clear policy and intention at the time the reforms were introduced, into a rate of return regulatory system – an approach to regulation which was never intended and which caused so many problems with developments such as gold plating and litigation-based regulation in the United States. The concern about regulator risk is now a potential major adverse influence on value and therefore on new investment in regulated assets.

In making this point it is nevertheless important to go back and highlight the first point made, that I think that the regulatory regime has worked well over all and it is in terms of the general emphasis of the approach that I am expressing concern.

Industrial and Commercial Consumers

In relation to industrial and commercial consumers, surveys show that initially for example, manufacturers in the Victorian Chamber of Manufactures, a majority of manufacturers changed their supplier, that deregulated customers actually used the market. They not only shopped around, but they actually chose a different supplier if they could get a better deal. Most achieved very substantial cost savings. The Chamber of Manufactures in an early survey found an average saving in energy costs of 10 percent. Further, companies were able, for the first time, to manage the risks, to choose whether they took pool exposure or they didn’t take pool exposure in negotiating deals with their suppliers.
More recently there have been some changes. Wholesale prices have trended up, although of course, this reflects demand moving up closer to supply. Producers have been exercising power so that, for example, recently we have been through periods where it was actually difficult to get a hedging contract, but I would suggest that this is actually the market working. These developments are the market sending signals both to the users of electricity and to potential investors, that there is a need for investment in new capacity. And the market is responding – that necessary capacity is being installed. On the other hand, in common with other customers, these industrial and commercial customers have seen reliability improve and certainly the customer-focus of the industry has improved compared with the days of a government monopoly.

Market and regulatory discipline have led to system upgrades, for example, better distribution, infrastructure for dairy farmers. For many, many years dairy farmers complained about sudden interruptions to power while they were milking their herds. That resulted – particularly in the west of the State – in an upgrade of the infrastructure. In part that came about from competition and, in part, it came about from pressure from the regulators.

**Residential Consumers**

For residential customers, the average electricity charge per unit fell by 20 percent in real terms from 1989 to 1999. Savings were also achieved by gas consumers as gas prices were pegged below the inflation rate.

In addition, when the reforms worked better than had been expected, the Government gave the benefit of that to residential consumer through the Winter Energy Bonus, a $60 reduction off the domestic consumer's electricity bill each year for three years.

I understand from John Tamblyn's office that since 1994, and disregarding the impact of the GST, which had nothing to do with our reforms, there have been very substantial savings ranging from 14 percent to 4 percent reductions in real terms in the price of electricity for residential consumers.

So even now, people are significantly better off than they were before the reforms were undertaken, just in terms of price. But the regulator's reports also show that interruptions to supply have been significantly reduced, disconnections for failure to pay are down by about half, new techniques have been introduced which benefit consumers. These include techniques such as “live working” where, instead of cutting consumers off supply for minor repairs, the
industry now makes the repairs with the system live, still supplying the customers. And in a basket of services which are compared against the performance of the SECV, the industry has done significantly better than the SECV used to do.

The introduction of choice for residential consumers has been delayed, but I would concede that there are very good reasons for that, principally around the issue of metering and the difference between distinguishing customer load at the wholesale and retail level. These are issues with which many electricity industries around the world are grappling.

**Power Sector Efficiency**

The power sector has certainly become more efficient. Power station availability, one of the most important single indicators of the proficiency and efficiency of the generation sector, has moved from 70 percent up to 95 percent plus. Stations which the State Electricity Commission (SEC) proposed to “mothball” or close down altogether, like Hazelwood, have had closed-down units re-opened, the overall station refurbished and are now a critically important part of the system. Newport Power Station, which many people thought had no value whatever, was not only sold, but has been refitted to increase its flexibility to play a key role in the system.

CBD infrastructure has been improved so that we no longer face the prospect of not being able to isolate a problem and have half the city off supply as happened just after the reforms were implemented.

Industrial relations in the industry have dramatically improved, indeed, I suggest most cannot remember the last time there was a significant labour relations dispute in the industry.

New investment has been very significant, especially in distribution, which had been allowed to run down under Government ownership. All of the upgrade in the interstate inter-connector, the extension of the gas grid and its connection to New South Wales and the current plans for new electricity peaking capacity projects show that the signals for new investment are working effectively in the interest of consumers. And finally, an integrated energy market has been established in which companies compete vigorously to sell both gas and electricity and are constantly looking for ways to extract synergies from their customer base in both areas and, indeed, in activities which would never have been undertaken by the old Government monopoly.
CONCLUSION

In the main, we got what we planned.

The reforms have raised interest in Victoria. The market works well and certainly better than most others. The Government and taxpayers have probably been the biggest winners. Investors and operators in some cases have been losers, but that represents benefit to both consumers and taxpayers and there have been some winners (principally in the regulated area).

If we look at the regulated outcome for customers, there has been a win/win outcome. Regulation generally has worked well, but like the curate’s egg, it has some downsides and perceived regulatory risk represents perhaps the most important single risk to effective investment in the industry in the future.

Business has used competition, people have shopped around, they have changed their supplier and as a result they have achieved the benefits of competition, both in service and prices. Households who are still regulated, have made price and service gains, but, I think, will do even better once they get the right to choose their supplier.

Energy is more efficient, and because the market is sustainable, the gains will continue to be sustained in the future.

We embarked on a path to a competitive energy industry sector, effectively regulated in its monopoly areas. We intended to create a sustainable and competitive market. We intended that consumers secure benefits in terms and services. We wanted to see the industries’ efficiency increase and their contribution to the economy increased. In large order, we reached our goals.