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Yes, we need to fix our policy, but not create a new mess

“Government is not the solution to our problem. Government is the problem.” — Ronald Reagan

When I read the calls to renationalise Australia’s electricity grids in last Friday’s papers, I felt like Alice in Wonderland — told to go down another rabbit hole for no good reason, rather than try to get back to the real world. Rather than create yet another policy disaster, we should fix our existing policy and regulatory mistakes.

The calls were sparked by a report released by the Australian Industrial Transformation Institute. Its author, Queensland University professor John Quiggin, proposed a government takeover of all electricity grids.

Soon after, South Australian Premier Jay Weatherill said that one option his government was considering was “to completely nationalise the system”.

Quiggin claims that “market failure” — the creation of a national electricity market and private ownership of grids — is to blame for high prices and reliability issues.

In fact, the real culprit isn’t market failure. It’s government failure. The NEM is a wonderful mechanism to promote the generation of electricity at the least cost and allocate electricity to its highest value uses, while private ownership promotes efficiency.

However, the NEM and grid businesses are strongly influenced by poor government policy and regulatory choices, such as the renewable energy target and the regulatory asset base approach to regulation. As I argued recently, it can be tempting to make yet more second-best choices rather than fix the existing ones. The end result is a third-rate mess that serves no one’s interests. That’s what Quiggin’s proposal would give us.

Private ownership per se hasn’t caused high prices, nor reliability issues. Quiggin notes that retail electricity prices have risen significantly since the NEM commenced in 1998. That’s true. But in defending government ownership, he says they’ve risen by similar amounts in states with government ownership and those with private ownership. Therefore, he must agree that private ownership doesn’t drive prices up. In fact, it drives them down.

The Productivity Commission’s 2013 inquiry into electricity grid regulation pointed out that the relevant measure to judge grid privatisation isn’t retail prices, but the contribution of grid costs to retail prices. It found that government-owned grids had significantly higher costs than privately-owned grids.

Yes, grid charges have risen substantially since 1998, even for privately owned grids. But the two main reasons are the substantial increase in the peakiness of demand and our dysfunctional regulatory regime. Peak demand drives a high proportion of grid costs. High growth in airconditioner use has made demand peakier; this would have happened regardless of grid ownership.

The regulatory asset base approach to setting maximum revenues has insulated grids from market risks and driven overinvestment, while the approach to setting a regulated rate of return has been overly generous.

Private ownership isn't to blame for reliability issues either. Indeed, the commission found that in the decade to 2009-10 (when renewables were less pervasive), states with privately owned grids had the best reliability statistics. South Australia — which now has the highest penetration of renewables — then had Australia's best grid reliability.

This belies AITI director John Spoehr's claim that current reliability issues are "not because of renewables, as has been spuriously claimed, but because the private market has failed to deliver".

Therefore, Quiggin's proposal is based on clay feet. Private ownership hasn't caused higher prices, nor lower reliability — quite the opposite, in fact.

Further, his proposal relies on a finance fallacy: that government ownership somehow reduces the cost of capital. The weighted average cost of capital for a grid reflects the riskiness of its cash flows, not who owns it. If a government buys a privately owned grid, those risks don't magically disappear (indeed, quite the opposite), they're just transferred to taxpayers.

Federal and state governments don't fall for this fallacy in providing directions regarding appropriate rates of return for government business enterprises. For example, the federal Department of Finance states that a GBE should earn a commercial rate of return sufficient to cover the cost of debt and the required return on equity.

Quiggin doesn't specify what return a national grid would earn. While he points to the "gap" between grids' rates of return and the government bond rate as evidence of "excess profits", he says that the gap is "unlikely to be closed completely". He also says that grid acquisitions would be bond financed and that "the revenue from the assets will be sufficient both to service interest costs and to repay the principal over time". Simple maths demonstrates that for this statement to be true, the nationalised grid would need to earn a rate of return about equal to the weighted average cost of capital.

Even if the grids could be bought at no premium to their RABs, interest payments would swallow all profits if the nationalised grid only earned the government bond rate; no principal would be repaid.

What return would be required to repay the principal in a reasonable period of time (say 20 years)? Even if low real government bond yields (1.3 per cent) persist, borrowing $100 for 20 years requires an annual payment of $5.71. Therefore, the nationalised grid would need to earn a pre-tax rate of return of 5.71 per cent — a 4.4 percentage point premium over the government bond yield. That's about the same as the current gap that Quiggin says is evidence of "excess profits". Therefore, even under very optimistic assumptions, Quiggin's proposal wouldn't reduce grid charges.

But seriously, why on earth would we want a government-owned national grid? Its RAB value would be about $100bn. That's almost as big as BHP Billiton. Imagine the government running that! All the evidence shows that government-owned grids are less efficient. The Productivity Commission has demonstrated they have higher operating costs. Bruce Mountain, from economics consultants CME, has demonstrated that they spend much more on capital expenditures, resulting in higher RAB values and grid charges.

Importantly, Quiggin's proposal would create a conflict of interest, as government would be both owner and regulatory rule-maker. An example of how disastrous this could be is Weatherill's writing up of the RAB value of government-owned SA Water by $694m two days before the regulator made its 2013 price determination, denying consumers substantial bill savings.

Fixing our existing policy and regulatory mistakes would be a blessing for consumers. Grid renationalisation would be a curse.Paul Kerin is adjunct professor, School of Economics, University of Adelaide. He is a former CEO of the Essential Services Commission of South Australia, which regulated retail electricity and water prices.

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