Energy crisis a blunder of governments, not a market failure

Self-perpetuating support: Prime Minister Malcolm Turnbull at Portland. Amy Paton

AFR, Gary Banks, 7 Apr 2017

Even by today's standards, the misleading, disingenuous and partisan nature of the energy policy "debate" seemed to have plumbed new depths. So be it, I thought, it's no longer my job to call out such things. But then a state premier went and made the following observation:

"We've got market failure. We know there is an investment strike. The private sector just isn't building power generation."

I must confess that this took the wind out of my sails – if you'll pardon the analogy. The electorate was being told by a political leader that the problems they were experiencing – high prices, failing supply and costly emergency measures – had nothing to do with the government. It was the fault of the private sector and its perverse refusal to invest in power generation.

The inconvenient truth is that the increasingly high prices for increasingly unreliable electricity are a direct consequence of the increasingly high utilisation of renewable energy required by government regulation. Energy markets are admittedly complicated things. However, the logic is unassailable that if a cheap and reliable product is penalised, while expensive and less reliable substitutes are subsidised, the latter will inevitably displace the former. No amount of sophistry, wishful thinking or political denial can change that basic economic reality.

Changing the mix of energy use away from low-cost but emissions-heavy fossil fuels has of course been the whole point. While Australia's own actions can have no discernible impact on global carbon emissions, let alone on Australia's climate, there is broad support for the idea that playing our part is a precondition for a joint international endeavour that could. This requires a leap of faith, but it is a legitimate policy objective, even if a particularly costly one for this country given its resource endowments.

The resulting costs and difficulties have been greatly compounded, however, by governments choosing a policy path that is essentially anti-market, one violating basic principles of demand and supply. The energy crisis is self-evidently not the result of market failure but of government failure.

The 18th century literary sage Samuel Johnson remarked that "a man is never more innocently employed than when engaged in making money". The actions of private investors are not hard to understand. They will generally not invest in a project unless the returns are likely to be sufficient to cover the costs and provide an adequate return on their capital – given the risks involved and the alternatives on offer. Following regulatory interventions, returns from fossil fuel generators have gone down, while the risks of investing in them have gone up. I suppose the consequent reluctance to invest could be called a "strike", if one needed an emotive term, but it is really just a rational response to the forces at work.

Unlike government enterprises, private companies cannot be relied upon to provide cover for a government's policy mistakes. In that light, the SA Treasurer's lament that privatising ETSA was "the worst policy blunder in the history of South Australia" may have not only been a big call, but more revealing than intended.

In blaming the private sector for Australia's energy problems, there is a real risk that the policy mistakes that led to it will be compounded by further policy mistakes, rather than leading to corrective actions that acknowledge regulatory error. We seem destined to end up in a third or fourth-best world, as economists express it, when the first or second best were well within reach.

Thus we observe at the federal level the threat of regulatory intervention to withhold gas exports for domestic use – while at the same time state and territory governments ban or curtail exploration and production. We even see governments re-entering the energy business. South Australia is to spend a lazy half billion dollars on a new gas generation plant. The Commonwealth is contemplating investing in clean coal generation using its $5 billion northern infrastructure fund, the Minister responsible declaring "the only people who can get rid of sovereign risks are the sovereigns"!

Then there was the dramatic announcement of a "nation building" expansion of the tri-governmental Snowy Scheme that had been rejected as uneconomic in the 1980s. Following the WA election, Western Power must also take its place on the privatisation "no go" list.

To add to the irony, we are seeing a new wave of interventions to help the very firms which emission reduction policies were intended to drive out of business. The Portland aluminium smelter, perhaps the most intensive user of electricity in the country – an operation requiring heavily subsidised power even when it was cheap – has received substantial additional taxpayer support to help forestall the inevitable.

The intervention spawned by the failure of energy/carbon policy accordingly looks to become a self-perpetuating process. It is disturbingly reminiscent of the conventional industry protection dynamic of times past, in which assistance to import-competing firms imposed costs on downstream users and exporters, who in turn demanded (and often received) assistance of their own.

Gary Banks was inaugural chairman of the Productivity Commission. This is an edited extract from the 2017 Infrastructure Oration which he delivered to Infrastructure Partnerships Australia in Sydney last night.