

"Overcoming the crisis of the Electric Power in Latin America and Caribbean Countries"

Delivered to the Mexico Power Sector Conference, 5th September 1991

Thank you for the opportunity to talk about New Zealand's experience in corporatising and privatising state business enterprises in order to improve the contribution they make to the wellbeing of New Zealanders.

It is clear that privatisation can serve a variety of different purposes. Some are complementary; others conflict with each other. The objectives, explicit or implicit of governments engaged in privatisation programmes around the world have, for example, included improved economic performance; improved management and control; improved consumer choice; more flexible labour markets; improved productivity; generating more revenue for government; reducing government debt; promoting popular capitalism; and promoting employee shareholding.

You get a much better price if you privatise a protected monopoly, provide a tax holiday to get it off to a good start and guarantee government purchases of the output at favourable prices. On the other hand, that approach produces nothing whatsoever by way of efficiency benefits. On the contrary, it can lock existing avoidable costs into the economy as a whole.

The objective of reform in New Zealand has, at every stage, been to maximise net benefit to the consuming public. It has been our aim to obtain the highest sale price achievable but subject always to that objective. Deregulation and the encouragement of competition have been seen throughout as fundamental to the public good. We have sacrificed sales revenue without question where necessary, rather than privatise a monopoly.

State businesses in New Zealand have been going through a two-stage reform process since 1985. Most state businesses have been converted from their original departmental structure into state-owned, limited-liability companies or corporations, in the first instance. Subsequently, once the business has improved its performance and after the government has tidied up the regulatory environment, reform moves on to the second state of full privatisation.

This mode of development has not occurred as a result of any particular philosophical position adopted a priori by the government. Traditionally, the New Zealand Labour Party has, for 50 years, been opposed on general philosophical grounds to most of the reforms implemented by the Labour Government when it took office in 1984. We had a situation in New Zealand where the attitudes, policies and philosophies adopted by both our major parties for 30-50 years have been seriously out of touch with reality and a liability to the nation.

From the early 1980s onwards, however, a rapid evolution occurred in the thinking of the Labour Cabinet and Caucus, as a practical response to the profound economic and social problems that had emerged over time as an outcome of our traditional approaches to policy. Back in the early 1950s, New Zealand used to have a dynamic, innovative land-based economy that was earning us the 3rd highest living standard in the world. But ever since the 1930s depression, we had been steadily raising barriers against international competition.

The goals of protectionist policy were increased urban employment and increased protection against international economic shocks. But it also caused our manufacturing to develop high cost structures that, to a large degree, precluded those industries from exporting.

Over time, the costs thus imposed on the economy gradually reduced the competitiveness of our agricultural exporters. These problems were further intensified by Britain's entry into the EEC and by the oil shocks of the 1970s. Balance of payments problems became endemic.

The then government, instead of facing up the real problems, sought to compensate farmers for those costs by subsidising them to boost export production. Public money was also used to persuade uncompetitive manufacturers to enter the export business and improve our foreign exchange earnings.

With the same objective, the government underwrote multi-billion dollar energy projects such as hydroelectric projects, oil refineries and a synthetic fuel project that had been rejected by the private sector as a bad commercial risk. Returns proved to be zero or negative.

In 1982, as the imbalances worsened, prices, wages, interest, rates and rents, were all subjected to direct controls by a conservative government. The distortions in resource allocations that were the underlying cause of our problems were compounded.

Our inflation, in the 10 years to 1984, was 1½ times the OECD average; our economic growth rate was half the OECD average; net public debt multiplied six times over; and debt servicing mushroomed from 6.5% to 19.5% of total government spending. Unemployment rose from 5000 to 132,000 with no sign of stopping.

The damage done by excessive protection is even clearer if a longer perspective is taken. In the 25 years to 1984, our average annual increase in productivity was, at 1.2%, the lowest in the OECD. Japan averaged 5.8% and the EEC 3.3%. By the early 1980s, our living standard was 32nd in the world - not 3rd. It had been falling by an average of one place a year for 30 years.

When do you call a halt and think again?

On the other hand, it would also be fair to say that, for a generation, most New Zealanders had seen high protection, not as a problem, but as the main safeguard of both employment and prosperity. Whenever problems arose, the normal government response in New Zealand was to lift protection a notch or two higher, to comfort those most affected.

By 1984, that whole approach was no longer sustainable. A run on the dollar occurred during the 1984 election campaign. By the time we took over, the banks had been forced to close their doors to all foreign exchange transactions. This was, then, in brief, the broad economic environment within which state sector business activity had been evolving for 30 years or so.

State-owned businesses in 1984 accounted for 12½% of GDP and 20% of total investment.

Nobody thought that government services were very efficient, but on the whole, they were seen as a pretty good deal. The relationship between these inefficiencies, the

performance of the economy as a whole, and the living standard of the community was not widely perceived.

The 1984 election proved to be a watershed in New Zealand history. Within 3 years from that date, New Zealand went from being one of the most highly regulated economies in the OECD to being one of the least regulated.

We freed interest rates, introduced a firm, anti-inflationary monetary policy, removed exchange controls and floated the New Zealand dollar. We phased out import licensing, and reduced tariffs across the board. Virtually all subsidies, tax perks and lending concessions for farmers were phased out.

The finance industry became one of the most deregulated anywhere in the world. The labour market, though still by no means the most flexible in the world, was made more responsive to market opportunity.

We reduced the top rate of personal income tax from 66% to 33%, and company tax from 45% to 33%. A wholesale sales tax with rates from 0-60% was replaced by a flat-rate 10% consumption tax across virtually all goods and services without exception.

The thrust of our policies was to put producers back in direct touch with their markets; to make them dependent on returns from the market; to expose all sectors, but particularly sheltered sectors, to increased competition; to level the playing field so that resources would flow automatically into the areas giving the best returns; to improve the incentives to effort and innovation; and thus encourage markedly better use by players right across the board of the resources they were consuming.

The reform of state owned business enterprises was therefore just one thread in a very much wider pattern of structural reform. To have a positive value to society, the output of such enterprises needs to be worth at least as much as the resources used to produce it. Their outputs need to be supplied with the least possible consumption of resources.

Neither of those criteria, however, had ever been central to the concerns of government or the managers of state businesses. They were controlled in the traditional departmental way by rationing inputs such as budget and staff numbers. Outputs, efficiency and performance were taken for granted or ignored.

Over the years, State Owned Enterprises - now known as SOES in our local jargon - had been given a conflicting mix of business, social and regulatory responsibilities. But neither ministers nor managers had any idea how much priority they were supposed to place on business efficiency, or how far they should forget it, in order to create jobs, provide cheap goods to the needy, or meet other social priorities.

Ministers, who were certainly not experts on business, ended up making business decisions. Commercial managers, right outside their own field of expertise, were forced to make social decisions. The outcome was reported to Parliament, but nobody knew what it meant. Responsibility was so blurred and divided that nobody's neck was ever on the block over the results.

Conflict between commercial and regulatory roles introduced unfathomable complexities. State Coal, for example, owned a majority of our coalmines. As regulatory authority for all coal mining, it had to decide whether new licences should go to its own commercial operation - or to private sector competitors!

Thirdly, SOEs often got their capital free from the government. They did not pay tax or dividends. This and many other factors created a situation where the costs appearing on their books bore no real relationship to the true cost of their activity. No one can manage that kind of system efficiently. The system does not produce the basic information required to do so.

A massive review of SOEs was therefore initiated, focusing on basic structures, and business systems. We knew the results would be bad, but none of us had the remotest idea how bad they really were, until the detailed results began to pour in.

Sloppy co-ordination was the norm. The Electricity Department had built a major power station on top of one of Mines Department's best coal seams. A new staff hostel actually subsided before it could be occupied, because the other department was mining coal underneath it.

During the previous 20 years, the government had poured \$5 billion of the taxpayer's money into these areas of activity. The return on that investment in the 1986-87 year was zero.

I therefore set myself to develop new principles designed to shift SOEs on to a commercial basis. The State Services Commission thought the idea much too radical. The Audit Office took umbrage - it infringed their authority. Some of the trading departments dug in for a long defensive war.

The progress of reform bogged down. Every conceivable attempt was made to delay, sidetrack, relitigate and reinterpret the thrust of the principles, and turn the government's nose in some other direction.

In the end, the log-jam was broken when, in December 1985, I announced a new set of principles for SOEs:

- State trading activities should have purely commercial objectives. If the Government requires any non-commercial activity to be carried out, that work should be budgeted clearly as a separate government activity. It would not be buried any longer within the trading activity of the State Owned Enterprise.
- SOEs should operate in a competitively neutral environment without advantage or disadvantage over other players. They should be set up with a normal commercial balance sheet. They should fund their activity in the normal way from the market, without concessions or guarantees. They should pay tax and earn a normal commercial return on the risk capital invested in them; operate under the same safety, labour market and environment rules, and so on.
- They should be organised in a form designed to facilitate the implementation of those principles.

Henceforth, directors and managers would be given clear business goals. They would have the autonomy to make their own decisions about how to achieve those objectives; the owners would hold them accountable on the basis of their performance in doing so.

A State Owned Enterprises Act introduced in 1986 created nine new SOEs to take over the trading functions previously handled by government departments: Airways, Coal, Electricity, Government Property, Land, Forestry, NZ Post, Post Bank and Telecom Corporation.

They were established under the Companies Act as autonomous limited liability companies with full legal power and appropriate accountability to both lenders and

owners. That set in motion an enormous process of change affecting one-eighth of the total economy.

Among the most important lessons learned from all our experience, let me emphasise this one as central - quality outcomes start with quality people. Getting the policies right will not be enough unless you also get quality people into all the strategic positions at the right time.

Let me now come back and use the electricity sector as an example of all this.

Prior to 1984, the bulk of generation and high voltage transmissions were organised as a government department - a division of the Ministry of Energy. Distribution was managed as non-commercial local boards with board members appointed by local election.

All key decisions that affected the Electricity Department were made by people other than the managers in the department; e.g. the capital works programme and major investment decisions such as new hydro-dams were reported on by Treasury and approved by Cabinet. Often the decisions were made for political reasons where jobs were involved.

Both Treasury and Ministers had totally inadequate information on which to evaluate the requests being made by the department. Wages and employment conditions were determined by another government department, the State Services Commission.

In order to attract electricity intensive industries, government became involved in negotiating long-term contracts with private sector companies that involved large subsidies. Construction contracts were reserved for the Government's Works Department.

The Minister of Finance set the electricity price as part of the annual budget. If government was concerned about inflation or there was an election coming up then electricity prices were held down. Usually after an election, or when the government was more concerned about its budget then prices went up. In some years the bulk electricity price rose by 60%. On another occasion the bulk electricity price rose by 40%.

In effect, every key decision that needs to be made in running an electricity utility was made by people other than the people running the department.

The inevitable result of this was that the managers of the Electricity department did not feel responsible for the performance of the department. They felt their job was to protect their department and gain as much resource as possible in the budget process.

Management performance did not really matter to them because there was no comprehensive or meaningful means of measuring the performance of the department.

In the electricity industry, there is strong political pressure to ensure the lights always stay on. In the 1960s New Zealand experienced a period of strong economic growth and there were a number of years when electricity shortages emerged.

The Electricity Department as a consequence gold-plated the transmission system and built in excessive reserve margins into new generation capacity programmes. A key issue for electricity utilities everywhere is the planning approval, financing and execution of major capital investments.

It is worth going into some detail as to how this now operates in New Zealand.

The first step was to ensure that Electricorp had an appropriate valuation. The aim was to establish a value that a willing but not anxious buyer in the private sector would pay for the business.

A key aspect of this is taking a long-term view of likely future needs for cash for major capital investment and then requiring the enterprise to fund major investment from its own retained earnings, borrowing or possibly, private sector participation.

The next step was to establish an appropriate debt equity ratio.

Initially the debt was issued to the Government but the SOE was required to transfer this debt into the private sector over a two or three year period. The New Zealand Government requires that SOEs loan documentation explicitly state that the debt is not guaranteed by the Government.

This is an important but sometimes overlooked discipline. While it raises the borrowing costs for the Government sector overall, it ensures that banks, rating agencies and investment analysts pay much closer attention to the commercial performance and risk profile of the SOE. It forces the SOE to become more professional and upgrade its management information systems and staff quality in the financial areas up to the standards of private sector companies.

Electricorp has moved from a situation where it had hardly any qualified accountants to a situation now where it is one of the largest and most respected New Zealand participants in the domestic and international capital markets.

The State Owned Enterprises Act requires each SOE to supply a draft statement of corporate intent to the shareholding ministers. The key issues which are debated between the corporation and the Minister each year are:

- The target rate of return on shareholders funds
- The level of the dividend to be paid
- The major business issues or strategies being adopted by the company.

Treasury and the State Owned Enterprises Advisory Unit play an advisory role to the Minister in these discussions.

This exercise is treated, as far as possible, as though the shareholding minister was a shareholder interested in the shareholder wealth and not simply short-term cash gains to the government budget. This is not always an easy role to play!

In New Zealand, the shareholding ministers have generally been risk averse. They are generally uncomfortable with capital invested outside the core business. The SOEs, acting as though they were private businesses often are keen to diversify into new businesses.

Because of the surplus of generation capacity resulting from previous policies, Electricorp, since its creation, has not been faced with the need to construct new generation capacity.

An example of how capital investments are now approved is Electricorp's largest new project it has undertaken since 1986 which is the upgrading of the HVDC link between the North and South Islands. This \$600 million (\$NZ) project was approved by the board and financed without recourse to government.

This was partially financed by a New Zealand dollar loan at a concessional rate of interest from Eksportfinans of Norway. The proceeds of the loan were used to finance the purchase of the submarine cables associated with the upgrading of the link.

The next issue I wish to cover is the organisational aspects of corporatising the Electricity Department.

The assets and business activities of the previous electricity department included:

- 95% of the total generation capacity in New Zealand
- 13,000 kilometres of transmission lines
- a 600 MW high voltage DC link between the North Island and the South Island
- A large engineering consultancy and construction operation.

An establishment board comprising top business people was appointed by government to oversee the formation of the new company included the negotiation of the asset valuation with the government.

The major steps undertaken by the new board included:

- Restructuring the company into four separate business divisions. These were production, marketing, transmission and power design build.
- Where the company lacked expertise, such as in marketing, management was recruited from outside the electricity industry.
- The transmission grid was separated to become a common carrier and provide greater levels of transparency. A number of independent and customer directors were appointed to the board of the national grid company.
- A strong marketing thrust was adopted to improve asset utilisation by increasing sales.
- Responding to competition by adopting lower prices.
- Developing flexible pricing options to better reflect dynamic cost signals to the marketplace.
- Establishing a high quality financial and treasury function.

A major reduction in staff levels was required reflecting the overstaffing that had developed as a government department. The Electricity Corporation undertook an innovative approach to this problem, one that was not necessarily adopted by other SOEs during their formation.

Every employee was required to apply for a newly created position. The Chief Executive appointed a number of managers who would report directly to him. In turn each manager appointed staff from existing employees and applicants from outside the organisation. Generous severance and job placement arrangements were put in place for those staff who became surplus.

This approach was important in the electricity industry to ensure that the staff "bought in" to the new business culture that was required. Many senior managers from the previous department did not find it easy to make the transition from the public service culture to the new commercially oriented culture. These managers found it difficult to adjust to the greater freedom and the increased requirements for accountability that should exist in good commercial organisation.

As I mentioned previously, high quality people in the right positions were essential in the success of this process. The Electricorp Board was a top quality as was the Chief

Executive. The influence that these people had in achieving major economic gains cannot be underestimated.

Electricorp has been free, since 1987 to set its own prices within the restrictions of New Zealand's general anti-trust legislation, the Commerce Act. The relevant feature of this Act is the ability for any party to take a case to the courts for alleged abuse of monopoly position.

The Act gives the Commerce Commission the ability to recommend to government that price control should be imposed.

This arrangement is known as "light-handed regulation". It relies on the threat of heavy-handed regulation if the freedom allowed for setting prices is abused, and where possible ensuring competition forces are maximised to impose a discipline on prices. Price control and rate of return regulation have well known problems associated with them in that they stifle incentives for efficiency and they create barriers to prices being adjusted in response to economic forces.

The Electricorp management is very aware of the political and public reaction if it is seen to abuse the freedom it has to set prices. The benefits of light-handed regulation are well illustrated by the Electricity Corporation example.

The company has responded to the light handed regulatory environment by:

- Voluntarily separating the monopoly national grid and operating this as a separate independent company.
- Reducing costs.
- Reducing wholesale prices.
- Launching a strong marketing campaign to make better use of existing surplus generating capacity.

Under traditional US style rate of return regulation the company would have had little incentive to increase asset utilisation or reduce costs because the resulting profitability improvement would need to be justified and probably blocked by a regulator. There are also strong incentives to increase the assets base. Electricorp on the other hand scrapped outdated power stations.

Under price control or price caps, the company would not have reduced prices because it would not be confident it could increase them again as the surplus capacity situation was worked off.

The light-handed approach to regulation relies on boards and management who believe that the prospect of being heavily regulated is far worse than the relative freedom they enjoy when lightly regulated.

In many countries, utilities in the United States for instance, businesses that have always been heavily regulated, understand and like being regulated and are actually afraid of the uncertainty created by deregulation. The success of introducing light-handed regulation in my view rests largely on introducing new attitudes, including a new breed of managers who do not accept the old way of doing things.

In New Zealand we found that management of many state owned enterprises actually adjusted far better to deregulation than the managers of many private sector firms that had to face deregulation in the form of reduced tariffs, the reduction of import licencing and so on.

I now turn to the current issues and options being dealt with in the electricity sector in New Zealand.

Given the dominance of Electricorp in generation, and the possibility of privatisation, the light-handed regulation was not entirely satisfactory to government. In 1988 the government created an electricity taskforce to advise on further structural and regulatory steps that could be taken to strengthen competition where this was possible and to isolate the natural monopoly parts of the industry.

The key issues that emerged from this study (*"Report of the Electricity Task Force, September 1989"*) and subsequent studies included:

- Should the national grid, being a natural monopoly, be separated from Electricorp to a greater extent so as to ensure that potential competing generators were confident that the existing dominant generator would not use its control of the grid to erect barriers to entry?
- Should Electricorp be split up to create a number of competing companies rather than allowing the entry of new generators to create competition over time?
- What sort of competitive wholesale market should be created?
- How could competition be introduced into retailing of electricity (i.e. the purchasing of bulk energy, transmission and distribution of energy and then retailing to the consumer)?
- Should the electricity industry be privatised and if so, how?

The issues are complex and I will touch on only a few key points:

The government is likely to decide to further separate the transmission grid by creating a so-called club of generators (initially Electricorp), distributors and possibly private investors. This would have specifically drafted rules that ensure the grid operates to promote competition and operates openly and transparently.

The question of separating Electricorp is extremely complex. The New Zealand electricity system is very small by the standards of international utilities. The reliance on cheap hydropower and the small number of thermal stations raises technical problems.

Most experts agree that competing companies are likely to effectively form a cartel to push prices up to about the same level that they would be under a single company. The separation would impose significant costs. Many believe that Electricorp has already become extremely efficient as a result of corporatisation and that therefore the costs of break-up are likely to exceed the benefits.

Another view however is that the creation of competition even at a net cost to the country is a political necessity if privatisation is to be acceptable to the public. The issue is still unresolved.

Much research has been undertaken over the past year or so into options for wholesale markets. This is also a complex area. A number of models are being considered. Intensive study has been made of the United Kingdom model. I understand that world leading research has been undertaken into the possibility of creating of transmission capacity rights to overcome the problems created by transmission constraints.

The government is proceeding with plans to corporatise the distribution sector. Commercially skilled directors have already been appointed to oversee the corporatisation process and some distribution authorities are already demonstrating impressive efficiency gains. Government has announced that legislation will be

introduced later this year to require the separation of line charges from energy charges and to require information disclosure of the monopoly part of the business. This could create an environment where competitive retailing could occur.

The government has not made any decisions on privatisation of the electricity industry.

I strongly support privatisation provided appropriate structural and regulatory arrangements are in place to maximise the potential for competitive entry into the industry.

The privatisation of Telecom last year has already provided a strong boost to the New Zealand capital markets; increased linkages with overseas companies providing opportunities for technology and skill transfer; and made a significant reduction in the overseas debt.

Telecom now has shareholders who are much better at evaluating and taking risk than the New Zealand Government. The same benefits would accrue to New Zealand if Electricorp were privatised.

The most important I believe in the case of electricity is the ability of private sector owners to evaluate risk. The electricity industry is actually very risky. The traditional perception that electric utilities are low risk is incorrect from the national point of view. Monopoly protection and government ownership has allowed the costs of bad decisions to be passed on to either consumers or taxpayers. The risks in the electricity industry are considerable.

There are large risks in construction overruns and poor forecasting of demand. New Zealand, as in many other countries, has a poor history of construction overruns and building of excess capacity. Privatisation will force these risks onto the private sector. This in turn should impose pressures to improve the management and productivity of major capital projects.

What lessons are there for Latin America and LAC countries arising from the New Zealand experience? The corporatisation model appears appropriate for many Latin American and LAC countries in terms of:

- Clarification of the role of government.
- Improving accountability.
- Improving the ability for government to monitor the performance of state owned company.
- Introducing private sector work practices and culture, particularly in respect of the labour market.
- Reducing the scope for decisions based on political rather than on a rational economic and business basis.

It is crucially important that ministers, politicians and government officials understand the importance of not interfering in business decisions made by SOEs. If managers are not made fully responsible for the decisions they make then they cannot be made accountable.

Many Latin American countries however have major problems with macroeconomic control and weak or undeveloped capital markets compared to New Zealand and other OECD countries that have carried out corporatisation programmes.

The World Bank is in some cases the only lender to government for infrastructure development.

The lack of properly functioning capital markets and the debt and macro stability problems faced by many Latin American countries suggest that possibly some form of privatisation should be taken much earlier, but not full sale of the state's ownership interest.

A model that I believe would be appropriate in Eastern Europe and could possibly be so in some Latin American countries is a form of joint venture management agreement with conditional agreements for privatisation.

A foreign private sector partner would be selected to help manage for instance an existing electric utility company on a management fee basis.

The partner would be given options to purchase a minority equity stake at a favourable price maybe three or five years in the future and with the right to purchase a majority stake at full market price. Full or partial privatisation would only be undertaken once a sufficient degree of macro stability had been achieved and capital markets had deepened and widened sufficiently.

The foreign private sector partner would:

- Introduce management and labour market reforms
- Undertake or advise on restructuring
- Undertake skill and technology transfer

This would add value to the company and ensure that the government receives a much better price when a decision is taken to fully privatise. This will ensure much greater contributions to debt reduction.

The economy receives the benefit of price reform, reduced subsidies, and increased productivity, which would assist with other macro-economic and micro-economic reforms.

The World Bank and International Finance Corporation could assist in providing financial and technical support to governments to develop such arrangements if they were regarded as desirable.

Private involvement in the planning, financing and construction of new capacity in the electricity industry is obviously desirable from the point of view of providing capital inflows, avoiding the need for government debt raising, increasing competition and enhancing skill and technology transfer.

A successfully corporatised state owned electricity utility sector will enhance the prospects of new generation capacity being provided by the private sector.

The key aspects of reform in my view are:

- Light-handed regulation where the basis for regulation is transparent and open. Prices must be allowed to reflect underlying economic forces. In particular when demand exceeds supply, prices should be allowed to rise to encourage more efficient energy use and to reward new entrants.
- Stability of regulation. A strong political commitment to the stability of the regulatory regime is obviously important. If price regulation is necessary then the

UK style price-cap with provision for efficiency improvements, in my view, is superior to rate of return regulation. Institutional strengthening of government departments and regulatory agencies may be required to improve the quality of regulation and advice.

- Separation of monopoly from competitive parts of the industry. Transmission lines, which form part of the grid and where open access is required in the future should be separated out and regulated and possibly owned on a separate basis from generation.
- Sanctity of contract. Investors must feel confident that contracts will not be effectively overturned by government action, including price freezes.
- Macro economic stability and strengthening of capital markets.

In conclusion, a well designed and executed corporatisation programme should deliver major efficiency gains to electricity entities and other utilities that are organised by government departments. Privatisation is also desirable provided the objectives of the programme are well thought out, competition introduced and the regulatory regime is structured correctly.