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# Current Comment

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## Comments on the comparison of a single electricity buyer and Pharmac

Lewis Evans

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## **The Single Buyer is Very Different From Pharmac**

The (Greens and Labour) proposed model of a single electricity buyer with price discrimination has been compared to Pharmac as if they were similar. The only feature they have in common is that both face some trouble in getting supplies and investment in New Zealand. In the case of Pharmac there are benefits to be balanced against these effects.

Pharmac funds pharmacological drugs on a list it approves for New Zealand. Drugs not on the list that have health and safety approval can still be used, but they are not funded in total or in part by the public health system. Drugs not on the list may not be routinely provided. This limits the ready availability of some, often new, less-proven drugs. Put simply, Pharmac is not a single buyer in New Zealand or on a world-stage.

Pharmac's benefit lies in procuring cost-effective drugs. Lower drug prices from Pharmac's hard-nosed negotiations have low downside because they will not affect future drug availability. New Zealand's consumption of drugs is negligible on a world scale. That means price reductions achieved by Pharmac do not affect drug company profitability or investment in research and development of pharmaceutical drugs in general.

In contrast, a single buyer in electricity will be a monopoly buyer in an industry where supply is sensitive to price. A single buyer may also have to be given regulatory powers to make operational decisions for suppliers. For example, there may be alternative uses for water that are more profitable than using it to generate electricity at the single-buyer price, meaning regulation would be needed to require generating companies to use water for power generation.

While Pharmac can reasonably ignore industry investment, the proposed single-buyer could not do so. Investment requires that costs be covered with some allowance for risk. The proposal threatens this in two ways. It would take away profit made by an established company at the going electricity price, and re-distribute it among households. If a company's recently established new plant was successful, it may soon have some of the resulting profit scooped off by single-buyer actions. Because investors know this is going to happen potential generation plants would likely not be established. There are presently renewable energy generation plants that have the necessary resource consents for construction: why would they be built in the shadow of the proposal?

A second reason is that the wholesale market for electricity is operating relatively effectively yet it is to be restructured with no definable purpose. The proposal entails reducing the price paid for electricity from particular sources of generation and lowering the price of electricity to households. The reduced price paid for electricity reduces returns to private owners. It reduces government revenue because government owns electricity companies and so will lose dividend revenue, and in addition receive less tax revenue from the privately held electricity firms because their dividends are lower. Assuming that the lost government revenue is to be replaced by increased taxation, the

proposal has embedded in it a tax/subsidy scheme where taxation sources household electricity consumption subsidies. Such a scheme for electricity could be implemented directly without restructuring the electricity market. In targeting the “market” in “electricity market” the proposal would produce an unstable commercial environment.

These are not matters a single-buyer or regulation could fix. Assurances or rules about what prices are to be set for different sorts of generation and for new or potential generators could only be assessed by investors against the purpose and action of the single-buyer, price-discrimination policy. The purpose would be that generation plant once established, particularly that such as hydro with high capital and low running costs, should have an amount of its operating profit removed.

The tax/subsidy and the investment effects of the proposal, combine to suggest increased regulation and centralised control that would go well beyond the model that is Pharmac.

It is tempting to draw comparison with health and education where the state does buy services. However in these, labour rather than capital, determines cost. Capital and date of establishment are less of a factor in costs and profitability and so there would be less opportunity for the price manipulation of the proposal. In the 1990s there was a health provider-buyer policy for public health. The buyer contracted for services from providers. It was abandoned in 2000 by the Labour government of the day.

The investment and price effects of the single buyer for electricity suggest that a better comparison would be the New Zealand Electricity Department of the 1960s and 1970s. In that era taxpayers paid, and politicians made pricing, investment and operational choices in the electricity sector. The associated planning and control of electricity produced some poor investment decisions and meant that the price of electricity was not its cost.