Tighter Rein Urged on Asset Revaluations

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A year ago, appearing before the Select Committee considering the Mixed Ownership Bill that opened the way for the partial sale of Mighty River Power, I warned that the regulatory risk overhanging the electricity industry had become severe, and that it would be unwise to proceed with any partial share floats without first ensuring that investors could be confident of a stable policy and regulatory environment. Specifically, I pointed out that "New Zealand's regulatory regime to date has been spectacularly lax by the normal standards of regulation in other countries, and any investor taking up shares in the pending floats of electricity SOEs will have to bear in mind the likelihood of a future policy shift that will more effectively remedy the obvious failings of the industry to date."

I drew the committee's attention to more than $10 billion of asset revaluations that the generator/retailers had credited to their books. That sum, which had risen to $12 billion by 2012, represents the present value of the amount by which those companies' profits are above what would have been needed to give them a fair return on all the money they have paid out, both to acquire their generation assets back in the late 1990s, and to install new assets since then. I pointed out that if one of the standard models of regulation used overseas had been applied here at the time ECNZ was broken up in the 1990s, most of those asset revaluations would have been prevented, because the industry's ability to price-gouge its captive customers and capitalise the resulting profits as "fair value" would have been blocked.

The central reason for regulating the New Zealand industry would have been to hold prices and asset values down to the lowest levels consistent with security of supply. One example of such regulation was introduced by Margaret Thatcher's government when it privatised electricity and other utilities in the mid-1980s. Britain's "RPI-X" regulation was designed to hold electricity price rises below the inflation rate, thereby forcing companies to pass through efficiency gains to consumers in the form of lower prices.

Much of the USA, meantime, continued with its long-established practice of rate-of-return regulation, which allows investors a fair return on all money they actually spend on building plant and equipment, but blocks them from helping themselves to the sort of "fair-value" revaluations that New Zealand generators have used to justify their price-hikes over the past decade.

So how big is the regulatory risk facing the electricity generators? Suppose a New Zealand Government regulates the big generator-retailers. The first decision would be to decide how much of the companies' declared book values would be allowed to stand. A US regulator would aim for a write-down to historic cost; a British one would settle for indexed historic

cost (that is, they would allow regulated asset values to have risen with the consumer price index since the assets were "vested" in the new companies). Either approach would sharply reduce the value of shareholders' equity in the companies and bring down the amount of revenue they would be allowed to collect from consumers. On the basis of the 2012 gentailer balance sheets, write-downs could total up to $12 billion, and revenue reductions could be well over $1 billion per year.

As a specific example of a New Zealand electricity company's exposure, it may be worth looking at the numbers for Mighty River Power. Mighty River's fixed assets had a so-called "fair value" of $5.1 billion at June last year, but the historic cost of those assets was only $2.2 billion. A regulator using historic cost could potentially require a write-down of nearly $3 billion, and a corresponding cut in revenues (achieved by price reductions) of between $300 and $400 million. The shareholders' equity was just over $3 billion at June 2012; most of this would evaporate as regulation came into effect.

Alternatively, a regulator could allow the company to set its prices to secure a fair return on indexed historic cost, in which case I estimate that the allowable asset base would be $3.1 billion, requiring a write-down of only $1.9 billion (about two-thirds of equity). Allowed revenue would be reduced by roughly $250 million a year.

In my submission to the select committee last year I proposed a regulatory regime based around historic cost and progressive pricing, and I commented that such a regulatory change "would be financially devastating for the balance sheets of the SOEs, in precisely the same way as their conduct has been devastating for the household budgets of millions of people". But the world would not end; the electricity market could continue to operate, and the existing companies would be able to trade forward once recapitalised. All that would have happened would be that their massive expropriation of wealth – a sum equivalent to around 5% of New Zealand's GDP - from ordinary consumers would have been reversed.

Graphic if interested (can redraw as required):