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Response to Commerce Commission's open letter "ensuring our energy and airports regulation is fit for purpose"

I welcome the invitation from the Commission to comment on the fitness of its regulatory arrangements. In particular I congratulate the Commission for leaving the way open for a wide range of comments. In this response I offer a number of brief points, any of which I would be happy to expand upon should the Commission wish to pursue them.

Over the past two decades I have been critical of what I regard as crucial problems both with Part IV of the Commerce Act 1986 (the Act) and with the Commission's application since 2008 of the Inputs Methodology developed under the Act. Key points I wish to re-emphasise here are the following:

1. The procedures implemented by the Commission comprise "regulation" in only a token sense, because the process was introduced after the capture and entrenchment of monopoly profits in unregulated natural-monopoly markets during the 1990s. That unregulated decade had by 2002 left monopoly rents capitalized into asset values, enshrining massive untaxed capital gains reflecting the so-called "fair value" of anticipated future rents, crystallised under the Optimised Deprival Value methodology. When those ODV values were rolled unchanged into the "Regulatory Asset Base" for Part IV regulation of the companies, and reclassified as deemed-historic-cost values, this process amounted to capture of the regulatory process at the outset by the monopolies, with consumers as the victims. At the time when the Commission was weighing consumers' interests against industry vested interests on this issue, I (along with Simon Terry) was one of those who made submissions in opposition to industry lobbyists[1]. We argued at that time that

> other things equal, the Commission should adopt whichever asset valuation methodology best serves the interests of consumers. If there are tradeoffs, then these should be quantified as far as possible to identify which methodology gives the greater net benefit to consumers.

   The Commission subsequently decided, against our advice and without refuting the cost-benefit calculation we offered, to entrench the monopoly valuations into its

[1] See http://www.geoffbertram.com/fileadmin/publications/Submission_on_lines_valuation.pdf and http://www.geoffbertram.com/fileadmin/publications/Supplementary_submission_on_Lines_valuation_methodologies.pdf.

regulatory asset base. The Commerce Amendment Act 2008 reinforced this victory for industry by prescribing Input Methodologies which have served primarily to shield the natural-monopoly companies from legitimate consumer complaints. The outcome is a classic example of regulatory capture, a subject on which I have recently published, with specific reference to the Commission's performance.[2] I have also on several occasions published my analysis of the outcome of the electricity industry's capture of the Regulatory Asset Base.[3] So long as the existing Regulatory Asset Base approach remains intact, the Commission will remain trapped in the asset-valuation dark ages that US regulators experienced between *Smyth v Ames* in 1898 and *Hope Natural Gas* in 1944. And so long as the Commission remains paralysed by the credible threat of litigation by the regulated industries in response to any threat to their treasured asset valuations, consumers - and the prospects for decarbonising the New Zealand economy at large - will remain hostage to bad regulatory decisions made two decades ago.

2. Looking ahead, the issue of who carries the burden of stranded assets deserves a better response than simply dumping it onto defenceless small consumers. A crucial feature of the way the Commission has developed and applied its Input Methodologies has been to put a ratchet under the Regulatory Asset Base, so that the RAB is quickly increased to recognise new investments, but never written-down to reimburse customers for past exploitation. This is notwithstanding the provision in s.52D()(a) of the Act that "clawback" can potentially be applied to compensate consumers for past over-charging. (The term "on a temporary basis" in that sub-section is open to quite a wide variety of interpretations.) The Commission's recent introduction of the idea of "accelerated depreciation" allows companies to raise their prices yet again to recover their valuation of assets that become stranded for whatever reason – a move that is consistent with the strong pro-supplier and anti-consumer bias build into the entire regulatory process, given the absence in New Zealand of any effective advocate for small consumers that might be able to counter the industries' deep-pocketed advocacy and the complexity and obscurity that surround the regulatory calculations and the presentation of disclosed information.

3. The information disclosure arrangements that underpin the regulatory process have become increasingly mired in obscurity, complexity and technical detail. Since the publication of disclosed information in the *Gazette* was discontinued after 2008, only the most determined and motivated individuals and organisations have been able to access and analyse the figures. Chasing up each company's material on that

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2 Geoff Bertram, "Regulatory capture in product markets and the power of business interests", *Policy Quarterly* 17(2) May 2021 pp.35-44, https://ojs.victoria.ac.nz/pq/article/view/6821/5969 .

3 For example Geoff Bertram and Dan Twaddle, 'Price-cost margins and profit rates in New Zealand electricity distribution networks since 1994: the cost of light handed regulation', *Journal of Regulatory Economics*, 27, 3 (2005), pp. 281-307, http://www.geoffbertram.com/fileadmin/publications/Price-Cost%20Margins%20and%20Profit%20Rates%20in%20New%20Zealand%20Electricity%20Distribution%20Networks%20Since%201994.pdf ; Geoff Bertram "Problems with the 'reformed' New Zealand electricity market", *IAEE Energy Forum*, (Second Quarter), April 2021, https://www.iaee.org/en/publications/newsletterdl.aspx?id=949 , and other references therein.

company's website, or trying to extract meaningful data from the Commission's Excel workbooks, is far beyond the resources or expertise of ordinary New Zealanders, who are consequently excluded from any proper consideration of the issues before the Commission. Journalists who, given access to properly-digested material, might be able to turn out intelligible accounts of Commission hearings and decisions, have long ago been deterred by the time and effort required. That obscurity has removed the Commission and the regulated industries from effective democratic accountability. The failure of transparency and accountability was dramatically illustrated by the extraordinarily shallow use of Commission data by the 2018 Electricity Price Review to claim there was no evidence of excessive profits being secured by lines networks.[4] The Review's five-year data window comparing disclosed rates of return on the grossly inflated Regulatory Asset Bases against the Commission's WACC came nowhere near providing any sort of genuine response to the Review's Terms of Reference which had asked, "whether suppliers of electricity services have the ability to extract excessive profits over time". My view on that particular episode is that the Commission did no favours to either its own reputation or the public interest by its complicity in what looked to many observers (including myself) like a whitewash.

4. The Commission has equally contributed to public confusion and mistrust by persistently confusing the words "price" and "revenue" in relation to the outcomes of its Part IV regulatory proceedings. By abdicating from any regulatory oversight of pricing, as distinct from general revenue recovery, the Commission has left open the way for electricity distributors and retailers to dump the bulk of their fixed charges onto the most powerless and dispersed consumers, namely households. The pending industry-driven abolition of the low-fixed-charge regime poses a major threat to the rapid deployment of distributed renewable generation options – especially rooftop solar – that ought to play a key role in the decarbonising of the New Zealand economy. By washing its hands of control over pricing, as distinct from revenue-setting, the Commission has effectively stepped away from what could have been a useful role in the energy transition mentioned in the Open Letter to which this is a response. If the Commission does wish to play a more positive role, it will need to overcome its reluctance to enter into the detail of the pricing of distribution as it flows through to the electricity bills facing final consumers who are also, either actually or potentially, prosumers.

5. Another aspect of the Input Methodologies that would benefit from serious re-thinking is the Commission's "CPI-X" procedure, which from the outset abandoned Stephen Littlechild's original idea of forcing the pace of efficiency-enhancing technical progress. Littlechild's idea was that p_0 should be set on the basis of actual costs, after which imposition of a downward-sloping price path would force efficiency improvements by the regulated firms. The Commission's procedure, in contrast, makes the setting of p_0 itself part of the CPI-X calculation, by treating that calculation as no more than a present-valuing of anticipated inflationary trends, thereby robbing it of serious meaning – hence the routine setting of X=0 in Commission decisions. I

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[4] Electricity Price Review *First report for discussion* August 2018, https://www.mbie.govt.nz/dmsdocument/3757-first-report-electricity-price-review-pdf , pp.53-54.

would suggest removing this routine entirely from the Input Methodologies unless the Commission is prepared to give it some genuine teeth.

Once again, I thank the Commission for providing the opportunity to offer these comments. I continue to hope that at some time in the future New Zealand's Parliament, Government, courts, and regulators will rediscover concern for the actual well-being of actual consumers, as distinct from the vacuous "long-term benefit of consumers" slogan that has, since the late 1980s, camouflaged official tolerance for the exercise of market power at the expense of the powerless.

Best wishes

Geoff Bertram