

The power and the profit

Geoff Bertram

The first report from the Electricity Price Review, set up by Energy Minister Megan Woods in April, declares that, after "a comprehensive analysis of existing data sources", there is "nothing to suggest distributors are making excessive profits".

This claim must have started most electricity consumers, after three decades of rising prices, high profits, and massive capital gains for network owners.

There's no lack of data. Since the 1980s, financial statements for each network have been published annually on the public record. Serious research into profitability would surely span the three decades since electricity supply authorities had their assets expropriated by act of Parliament, were transferred into corporatised monopolies, and were then put under regulated-for-a-decade, and finally become regulated monopolies. In 2008.

Incidentally, the price review looked at only the past five years of data, from 2012 to 2017. During that period the electricity network companies collected just enough revenue to give them a commercial return on the value of their assets, as determined by the Commerce Commission.

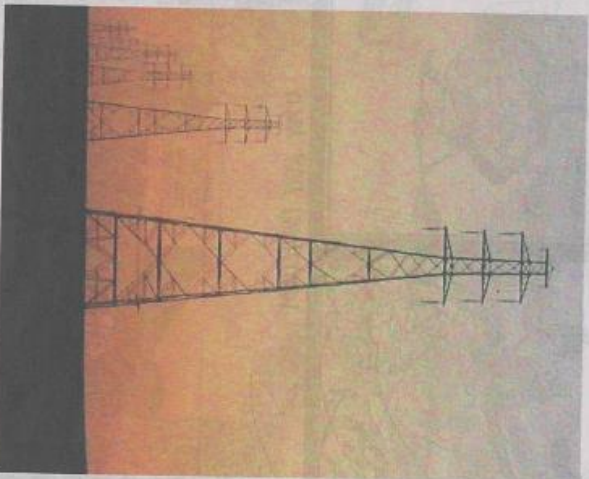
The price review asked whether the sector's profits represented a commercial return on the asset values set by the commission. Finding that the answer was yes, the review announced "no excess profits". But what is this "regulatory asset value" against which profits are evaluated, and why did the price review not look back before 2012?

Consider the Wellington and Hutt electricity networks. Back in the early 1990s, electricity customers paid those networks about \$85 million a year. Of that, \$40m went to pay for operating costs, and \$14 million was invested in new network assets. Effectively, all the money paid by users was ploughed back directly into the service.

Fast forward to the five years 2012-17. Excluding Transpower charges, users paid \$15.5m a year for the same network services. Operating costs were \$58m a year. Capital spending averaged \$30m a year.

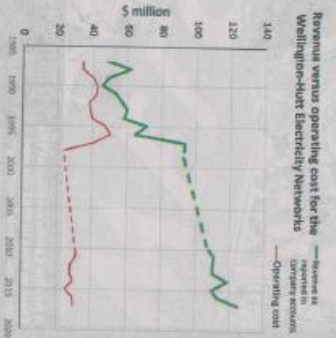
Just half the money collected from users was ploughed back into operating costs and new investment - \$27m a year went to pay tax; the other \$31m went as clear returns to investors after covering all operating costs, capital expenditures and tax payments. Excessive seems a reasonable description.

Back in the early 1980s, the government promised, first, that corporatisation and



Rather than corporatisation and privatisation leading to reduced prices for electricity customers, instead, as costs were driven down, prices have gone up, sending margins through the roof.

privatisation would bring costs down and, second, that cost reductions would pass through to lower prices. Instead, as operating costs were driven down, prices went up, sending margins through the roof.



that company's looks at \$81m, of which \$55m is "goodwill" - an accounting expression that extracts profits from customers.

Writing up assets, obviously enough, reduces the apparent rate of profit. That's the trick the Commerce Commission signed off when it established its "regulatory asset base". That's why the commission's regulatory accounts for 2012-17 don't reveal any "excess profits". The smoking gun lies buried under a mountain of asset revaluations.

Connoisseurs of tax avoidance will enjoy the sally in the tail of this story. In 2017, Wellington Electricity reported an after-tax loss of \$3m on revenues (this time including Transpower charges passed through) of \$180m, with operating costs (again inclusive of Transpower charges) of \$107m, leaving a gross margin (ebitda), after some minor items, of \$41m. "Depreciation and amortisation" took \$20m of this, tax took \$3.7m, and "finance costs" - 1001 \$50m.

The company's debt at the end of 2017 was \$722m - 153 per cent of the book value of fixed assets. Of this debt, \$24.5m was owed to a related party in Hong Kong at an interest rate of 8.75 per cent.

Last May, the Australian Tax Office won a landmark court case against Chevron Australia, which had used a similar related-party loan arrangement to transfer excess profits out of Australia and thus avoid paying tax. Time perhaps for Inland Revenue to check the tax accounts of Wellington Electricity? Certainly, time for the price reviewer team to take a more serious look at all the data - not just those sanitised five years.

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Excess profits in electricity distribution

The first report from the Electricity Price Review, set up by Energy Minister Megan Woods in April this year, declares that after “a comprehensive analysis of existing data sources” there is “nothing to suggest distributors are making excessive profits”. This claim must have startled most electricity consumers, after three decades of rising prices, high profits, and massive capital gains for network owners.

There’s no lack of data. Since the 1960s, financial statements for each network have been published annually on the public record. Serious research into profitability would surely span the three decades since electricity supply authorities had their assets expropriated by Act of Parliament, were transformed into corporatised monopolies, were then left unregulated for a decade, and finally became “regulated monopolies” in 2008.

Inexplicably, the Price Review looked at only the past five years of data, 2013 to 2017. During that period the electricity network companies collected just enough revenue to give them a commercial return on the value of their assets, as determined by the Commerce Commission. The Price Review asked whether the sector’s profits represented a commercial return on the asset values set by the Commission. Finding that the answer was yes, the review announced “no excess profits”. But what is this “regulatory asset value” against which profits are evaluated, and why did the Price Review not look back before 2013?

Consider the Wellington and Hutt electricity networks. Back in the early 1990s, electricity customers paid those networks around \$55 million per year. Of that, \$40 million went to pay for operating costs, and \$14 million was invested in new network assets. Effectively all the money paid by users was ploughed back directly into the service.

Fast-forward to the five years 2013-2017. Excluding Transpower charges, users paid \$115 million per year for the same network services. Operating costs were \$29 million per year. Capital spending averaged \$33 million per year. Just half the money collected from users was ploughed back into operating costs and new investment. \$2.7 million per year went to pay tax; the other \$51 million went as clear returns to investors after covering all operating costs, capital expenditures and tax payments. Excessive seems a reasonable description.

Back in the early 1990s Government promised first, that corporatisation and privatisation would bring costs down, and second, that cost reductions would pass through to lower prices. Instead, as operating costs were driven down, prices went up, sending margins through the roof. If the old supply authorities had continued unchanged, even with no average-cost savings at all, and if their capital spending had been equal to the actual figures, then over the past five years network charges would have been \$83 million per year – not \$115 million.

Monopolists routinely put a value on their assets for accounting purposes. Turned loose to price-gouge their captive customers after 1994, the owners of the Wellington-Hutt networks were sitting on a gold mine. Network operations with a historic-cost value of \$127 million were bought by TransAlta NZ Ltd for \$320 million, then sold to United Networks in 1998 for

\$590 million. In 2008 the networks went to another eager buyer, Wellington Electricity Distribution Network Ltd, for \$785 million. The non-current assets are now valued on that company's books at \$881 million, of which \$256 million is "goodwill" – an accountants' expression that means, in this case, monopoly power exercised to extract profits from customers.

Writing-up assets, obviously enough, reduces the apparent rate of profit. That's the trick the Commerce Commission signed off on when it established its "regulatory asset base". That's why the Commission's regulatory accounts for 2013-17 don't reveal any "excess profits". The smoking gun lies buried under a mountain of asset revaluations.

Connoisseurs of tax avoidance will enjoy the sting in the tail of this story. In 2017 Wellington Electricity reported an after-tax loss of \$3 million on revenues (this time including Transpower charges passed through) of \$195 million, with operating costs (again inclusive of Transpower charges) of \$106 million, leaving a gross margin (EBITDA), after some minor items, of \$84 million. "Depreciation and amortisation" took \$32 million of this, tax took \$3.7 million, and "finance costs" took \$50 million. The company's debt at the end of 2017 was \$722 million - 123% of the book value of fixed assets. Of this debt, \$234.5 million was owed to a related party in HongKong at an interest rate of 8.75%.

Last May the Australian Tax Office won a landmark court case against Chevron Australia, which had used a similar related-party loan arrangement to transfer excess profits out of Australia and thus avoid paying tax. Time perhaps for Inland Revenue to check the tax accounts of Wellington Electricity? Certainly time for the Price Review team to take a more serious look at all the data – not just those sanitised five years.

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