

28 January 2022

James Stevenson-Wallace
Chief Executive
Electricity Authority
By email to reviewconsultation2021@ea.govt.nz

Dear James

Market Review – supplementary evidence

1. On 22nd December 2021 the Major Electricity Users' Group (MEUG) submitted on the Electricity Authority (EA) information paper, "Market Monitoring Review of Structure, Conduct and Performance in the Wholesale Electricity Market, since the Pohokura outage in 2018."¹ Paragraphs 26 to 29 of that submission contained a section titled "Further context: Economic Profits earned by the large suppliers", where we explained we had commenced a pilot Economic Profit Analysis (EPA) for Contact Energy (CEN) and could not meet the submission deadline, but intended completing that work in 2022Q1.
2. The pilot EPA for CEN has now been completed. The attached 3-page memorandum summarises the results of that work. That summary report along with detailed background information used in the analysis will be posted on the MEUG web site shortly.
3. MEUG's next step is to consider the results with the earlier pilot EPA for Meridian Energy. That will assist us in deciding the next steps such as, continuing to undertake pilot EPA on the remaining large suppliers to gain better insights into economic profit trends over the last decade by individual generators and the industry.
4. We would welcome an opportunity to discuss the attached memorandum and prior submissions on the use of EPA as a technique for monitoring economic profit trends over time for the industry. A key topic for discussion is the treatment of revaluations and related effects. Page 3 of the attached memorandum is relevant. Also relevant is the attached extract from the pilot EPA for Meridian Energy Q&A on the treatment of revaluations.

Yours sincerely



Ralph Matthes
Executive Director

¹ Refer <https://www.ea.govt.nz/assets/dms-assets/29/MEUG-submission-Market-Monitoring-Review-of-structure-Conduct-and-performance.pdf>

Attachment

Extract from MEUG Q&A on Economic Profit Analysis (EPA) methodology and results for Meridian Energy Ltd (MEL), 24th August 2021²

Qu. 12.	<p data-bbox="336 443 1385 488">How were accounting revaluations treated?</p> <p data-bbox="336 495 1385 528">For the Economic Profit Analysis (EPA) accounting revaluations were reversed.</p> <p data-bbox="336 539 1385 752">Meridian Energy revalued property, plant, and equipment assets (PP&E) continually over the 21-years of the analysis. Cumulative revaluations total \$7.6 billion. Revaluations have been made without a corresponding recognition of the annual gain/loss in the accounting Income Statement. IWA has reversed revaluations to reflect what would be normal historic cost accounting. In other words, absent revaluations we get normal historic cost accounts. For Meridian Energy, the largest adjustment has been for revaluations.</p> <p data-bbox="336 763 1385 864">A treatment of revaluations was described by the Commerce Commission in their December 2010 Reasons Paper when setting the first Input Methodologies (Electricity Distribution Businesses and Gas Pipeline Businesses):²⁰</p> <p data-bbox="408 887 1329 987">"If regulated suppliers were permitted to increase their prices to reflect a change in replacement cost, without the revaluation gain being treated as income, regulated suppliers would not be limited in their ability to extract excessive profits."</p> <p data-bbox="336 1010 1385 1267">The above principle of recognising valuation changes in the income statement to ensure appropriate measurement of profits applies to all businesses, not just regulated suppliers. Few businesses in New Zealand revalue assets and take gains and losses to the Income Statement other than some Investment and Property companies. Electricity suppliers treat revaluations in different ways. Meridian Energy most recently have revalued in most years. Contact Energy stopped revaluing PP&E in 2014 and deemed the current value as historic cost.</p> <p data-bbox="336 1279 1385 1424">An alternative to our approach of reversing accounting revaluations would have been to retain asset revaluations and adjusted Meridian Energy's accounts by having corresponding recognition of the revaluation changes in the accounting Income Statement. Both reversing revaluations as we have done, or adjusting the Income Statement, is a non-trivial exercise.</p> <p data-bbox="336 1435 1385 1749">We chose to reverse revaluations as that appeared to be the least difficult of two complex options. In theory over a long period of years, applying EPA to a set of financial statements where there are no asset revaluations, or applying EPA to accounts where revaluations are treated consistent with the Commerce Commission approach of recognising changes in the Income Statement, will lead to similar if not identical (over a sufficiently long period) estimates of cumulative economic profits. A benefit of MEUG's EPA for Meridian Energy compared to other analysis is that we have used a long historic accounting record. Other analysis using only a few recent years have the difficulty of estimating the opening asset value and how to allocate prior revaluations to past of future periods.</p>
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² Refer <http://www.meug.co.nz/node/1150>. Note a subsequent correction to the fourth paragraph of the above extract. The reference to CEN stopping revaluing PP&E in 2014, should have referred to 2010.