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Frank Wolak: Tight electricity regulation only sensible option

By Frank Wolak
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According to data from the Ministry of Economic Development, average residential retail electricity prices have almost doubled since 2000. Photo / Mark Mitchell

There is not a lot to like about residential electricity prices in New Zealand.

According to data from the Ministry of Economic Development, average residential retail electricity prices have almost doubled since 2000. This had led to calls for drastic reforms of the industry to better serve the interests of New Zealanders.

This desire to "reboot" the electricity supply industry is understandable, but it is almost certainly not the best course of action. As a participant in many electricity industry restructuring processes around the world, one important lesson that I have learned is that all reforms start with significant unintended defects that can only be eliminated through a rigorous ongoing analysis of market outcomes and targeted regulatory reforms.

Many features of the current industry structure are consistent with international best-practice and a number of positive changes have been implemented since I completed my report for the Commerce Commission in 2009.

Continuing these efforts to identify and fix flaws in the existing market is likely to provide greater long-term benefits than undertaking a major restructuring of the industry.

By saying this, I do not want to imply that only minor changes are needed. Significant changes in how the industry operates and the government regulates it are necessary to ensure that consumers realise the full benefits they were promised from restructuring.

A major step in the reform process is to establish a regulator for the industry with a statutory mandate to protect electricity consumers from economic harm.

For many years, New Zealanders touted the government's unique "light-handed" approach to regulation of its infrastructure industries. This always seemed to me to be a contradiction in terms because effective regulation as practiced in North America and Europe is anything but light-handed.

It is often the case that the regulator collects data from market participants that they do not want to provide or sets a price or terms of service that adversely impacts the profits of the firm. These actions are typically taken because of the regulator's statutory mandate to protect electricity consumers from economic harm.

There are a number of legal rights that a regulator must have.

First, the regulator must have the ability to request any information from market participants necessary to carry out its statutory mandate, receive this information in a timely manner, and have the authority to impose financial penalties on market participants that fail to provide the requested information in a timely manner.

The regulator should also be allowed to require that all of the firms that it regulates prepare balance sheets and income statements using a standardised accounting system designed by the regulator. These accounting systems will allow the regulator to carry out the very important task of setting prices for monopoly services such as transmission access and distribution network access.

The regulator should be required to set prospectively the price of these monopoly services to allow the firm the opportunity to recover the prudently incurred cost of providing these services.

This does not mean that the firm is guaranteed full cost recovery regardless of how it incurs these costs. Because its price is prospectively set by the regulator, the firm's revenues are independent of any actions it takes, so it has the opportunity to recover these costs if it incurs them in a manner consistent with what the regulator deemed to be reasonable when the price was set.

The final right of the regulator is to set the market rules governing the operation of the wholesale and retail markets.

Rather than allowing market participants to determine the terms and conditions governing participation in these markets, the regulator must set these market rules to protect the electricity consumers from economic harm. Market participants and other interested parties can provide input to this process, but ultimately the regulator must set these market rules because of the enormous impact they have on wholesale and retail electricity prices paid by consumers.

An essential feature of this redesigned regulatory process is an ongoing market monitoring process where the regulator uses data compiled from market participants and data submitted to and produced by the market operator to undertake market performance analyses. Although this market monitoring process is extremely data and human resource intensive, it is necessary for the regulator to anticipate significant market performance problems and take action to ensure a small problem does not become a large problem that harms consumers.

Another role of the regulator is to provide transparent information to customers on the components of retail electricity prices. Each retailer should provide the same standardised breakdown of a consumer's monthly bill into separate charges for use of the transmission network, use of the distribution network, purchase of wholesale electricity, and electricity retailing services. The prices for use of the transmission and distribution networks are monopoly services and should therefore be set by the regulator as described above. Providing this information will allow customers to find the best deals for the competitively provided components - wholesale electricity and electricity retailing services.

A number of New Zealand commentators have argued that the country is too small to afford an international best-practice regulatory oversight process. The events of the past 15 years provide strong evidence that the cost of not having a rigorous world-class regulatory process for the electricity supply industry is extremely high.

Frank Wolak is director of the Programme on Energy and Sustainable Development and Holbrook working professor of commodity price studies with the department of economics, Stanford University, California.

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