

# Electricity Networks Association

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Dear Karen

## **Input Methodology Determination Amendments**

We refer to the recently published 'Consultation on Electricity and Gas Input Methodology Determination Amendments 2012' paper dated 11 May 2012. This sets out a planned amendment to the Commerce Act (Electricity Distribution Services Input Methodologies) Determination 2010. The ENA appreciates the opportunity to comment on this proposal. A further planned amendment to the Input Methodology (IM) Determinations for gas pipeline businesses (GPBs) regarding the 'disclosure year' has not been considered by the ENA.

## **Asset Acquisitions**

It is proposed that the asset valuation IMs (currently Part 2 Subpart 2 which applies to information disclosure regulation (IDR) and Part 5 Subpart 3 which applies to customised price-quality path (CPP) regulation) are amended. The proposed modification is in respect of the value to be assigned to assets which are acquired from related parties, when determining the regulatory asset base (RAB).

The IMs were determined in December 2010. The RAB IM is made up of two key methods: determining the Initial RAB and the RAB roll forward method. The former is limited to establishing value at 1 April 2009 (for EDBs), while the latter is applied from that date onwards. The roll forward methodology addresses asset additions, disposals, depreciation, revaluations, lost and found assets, and asset sales and purchases.

In prescribing the value of asset additions in the roll forward method, the underlying IM method is that assets are included in the RAB at values which are consistent with GAAP where possible. This approach was supported by the ENA as consistency with GAAP enables regulatory information to be drawn from existing financial reporting systems and processes. This minimises compliance costs. In addition, GAAP provides a set of rules for defining asset 'cost' which are applied consistently

by regulated suppliers and which are well understood by finance managers, auditors and readers of financial and regulatory statements. The ENA continues to support reliance on GAAP where possible for the reasons set out above.

In developing the RAB roll forward component of the IMs, the Commission specified a limited number of exceptions to including asset additions at 'cost' determined in accordance with GAAP. It was deemed these were more appropriate in meeting the purpose of Part 4 of the Commerce Act.<sup>1</sup> Accordingly, the IMs determined that assets acquired from related parties were to be included at their depreciated historical cost (DHC) by applying GAAP, or where insufficient records were available, at market value as determined by a valuer.

The Commission has now reconsidered the value of assets acquired from related parties for the purpose of the RAB IMs and believes an alternative approach will better meet the Purpose of Part 4. The ENA supports the review of this component of the asset valuation IM which seeks to clarify the intent of the relevant clauses and introduce alternative options which may better suit certain related party arrangements.

It is now proposed that assets acquired from related parties be included for the purpose of the RAB roll forward at:

- Cost to the EDB by applying GAAP, where certain evidence exists to confirm that cost reflects arms length pricing principles or arrangements; or where the value of such transactions is not material; or
- DHC to the related party, providing sufficient records exist; or
- Market value as determined by a valuer; or
- Nil value (where none of the other options are able to be met).

The ENA supports the inclusion of the option of 'cost to the EDB' where arm's length principles or materiality thresholds can be met. We comment further on the specification of those principles and thresholds below.

#### **Default Option Inconsistent with Part 4**

The ENA submits that the inclusion of the default 'nil value' option is inconsistent with Part 4 of the Commerce Act. In particular we note that section 52A (1)(a) requires Part 4 to ensure that suppliers of regulated goods or services have incentives to innovate and to invest, including in replacement, upgraded, and new assets. The inclusion of 'nil value' as a default option potentially penalises those EDBs which have elected to establish service providers as subsidiaries or separate commercial entities over those which have retained these services within the EDB. There is no 'nil value' option for EDBs which source their asset related services in-house. The asset valuation IM specifies that these EDBs include their commissioned assets at cost to the EDB.<sup>2</sup>

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<sup>1</sup> We note that the ENA did not support all of the departures from GAAP which were ultimately incorporated into the RAB IM, particularly where they imposed additional compliance costs with little perceived benefit for example in relation to 2.2.11(2) cost of financing allowances in the value of commissioned assets.

<sup>2</sup> Subject to the specific provisions, which apply under a limited number of circumstances, as set out in clause 2.2.11.

The Consultation Paper explains that the 'nil value' option is to incentivise a supplier with a material amount of related party transactions to take the steps necessary to adopt one of the other options. As previously submitted there are valid reasons for EDBs establishing related parties to provide asset related services. These are acknowledged in the Consultation Paper at paragraph 48. However the implications of the proposed approach is that if the EDB is unable to meet the proposed materiality thresholds or arm's length criteria, then assets must be included in the RAB at DHC, market value or nil. While we recognise that the proposed amendments introduce additional options for valuing related party transactions, the introduction of the nil value default option is of concern to us. We do not believe that it will be possible for all EDBs with related party providers of asset related services to meet the proposed new materiality thresholds or arms-length principles as proposed. This reflects the nature of the markets for these services and the difficulty in acquiring the evidence proposed, in the absence of active markets in many locations.

Further, it is not possible to apply the DHC option for some of the asset related services provided to an EDB, as it is the EDB which creates the asset not the related party. Finally the market value option is extremely cumbersome for some of the asset related transactions which may occur between a related party and the EDB, such as where construction services, projects or programmes are provided rather than discrete assets. Accordingly it is probable that the nil value may apply simply because it is not practical to achieve any of the other options.

We have previously considered the incentive effects of regulating the value of related party transactions.<sup>3</sup> We believe that the incentives that potentially arise from the proposal are inconsistent with Part 4. Accordingly we submit that the default option should not be 'nil value' but 'directly attributable cost'. This can be defined with reference to GAAP ie: 'cost to the Group to which the EDB and related party belong'. On consolidation, related party margins for services supplied to the EDB are eliminated under GAAP. This will ensure that those with related party arrangements are not penalised in comparison to those with in-house arrangements. It will also retain incentives to achieve transaction value should arms-length principles be able to be demonstrated in practice, or market valuations obtained.

## **Review of Information Disclosure Requirements**

One of the triggers for the proposed amendment has been the current review of the IDRs, which includes consideration of the disclosure requirements for all related party transactions. The treatment of related party transactions is a topic which the ENA considered at length in response to the recent IDR Consultation Paper.<sup>4</sup> In our submission, we challenged the intent of the draft IDRs to step into, and modify the value of the transactions between EDBs and their related parties. We deemed this was inconsistent with the purpose of ID.<sup>5</sup>

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<sup>3</sup> Refer NERA, Treatment of Related Party Transactions, A report for the ENA, 9 March 2012

<sup>4</sup> Information Disclosure Requirements for Electricity Distribution Businesses and Gas pipeline Businesses, Draft Reasons Paper and Draft Determination, 16 January 2012

<sup>5</sup> ENA Submission on Information Disclosure Requirements for Electricity Distribution Businesses: Draft Determination and Draft Reasons Paper, 9 March 2012, paragraph 120

In addition, and in response to the Commission's proposals for a set of criteria to be included in the IDRs to determine under which circumstances the actual transaction value may be recorded in regulatory statements, we proposed an alternative approach. This included a revised set of criteria that we believe is more consistent with the purpose of IDR.<sup>6</sup> The purpose of our criteria was to establish the information which should be made available to interested parties to enable them to assess the performance of the EDB consistent with the purpose of IDR.

Although the Consultation Paper refers to the prior work and submissions received in response to the Draft IDRs, it does not draw any linkages between those submissions and the proposed amended IM. The criteria set out in the draft IM differ from those proposed in the draft IDRs, and those proposed in our earlier submission, but it is not clear why this is so. As the Consultation Paper does not explain how its criteria were developed it is difficult to comment on the reasonableness or otherwise of the targets which are included in these proposed criteria. We refer the Commission to our earlier submission and encourage the Commission to reconsider its proposed materiality thresholds and arm's length rules in view of the alternatives we have already put forward. We consider that the criteria we have previously submitted are consistent with the materiality thresholds and arm's-length principles approach that are currently being proposed for the asset valuation IMs.

## **Interpretation**

The ENA does not believe that the proposals and accompanying Consultation Paper have sufficiently considered the range of transactions that occur between related parties in relation to 'assets' (for example the provision of asset construction services, the supply of material components or the purchase or transfer of an existing asset) and how each of the options proposed could be met in practice.

The IM implies that the process for determining which option applies, when valuing an asset acquired from a related party, is relevant at an asset level (ie: for each asset). However a number of the criteria are better applied at a transaction level or in relation to a contract. Both of these are likely to involve many assets. A contract may also involve many transactions. It is not reasonable to require Director's certification for every asset that may be captured by the proposed criteria. Certification should only apply at a contract level. Similarly the market valuation option should be applied at a transaction level, not an asset level.

## **Implementation**

We believe that the practical implementation of the proposals, as currently drafted, requires further consideration. Firstly the Consultation Paper provides no information regarding the proposed implementation of the amended IDR asset valuation IM. It would be unreasonable to require EDBs to retrospectively restate the value of their asset additions, particularly where the restatement involves a departure from GAAP. In addition, it would be unreasonable for the Commission to require

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<sup>6</sup> Ibid, paragraphs 121-128

EDBs to retrospectively compile the evidence required to meet a set of criteria that did not exist at the time the various related party transactions took place.

The modifications are also proposed for the asset valuation components of the CPP IM. The Consultation Paper does not include a draft of the proposed amendments for the CPP IM. As the CPP IM is forward looking, as opposed to the IDR IMs which are backward looking, it is not clear to us how it will be possible to apply the proposed approach in practice, for example how could market values be forecast. We believe that the intent of a CPP proposal is for the supplier to set out its proposed capex and opex programme, including sufficient evidence to support its proposed approach to implementing the programme and to justify its cost estimates. Where work is planned to be undertaken by related parties or material components or assets supplied by related parties, the proposal would set out its justifications and the Commission would form a view on that. Relevant information is already specified in Schedule D of the CPP IM. Accordingly, for the purpose of the CPP IM, the value of additions acquired from related parties should be included at cost to the EDB unless the Commission deems, following its assessment, that an alternative value is more consistent with Part 4.

We suggest the Commission consult further with auditors as to the practical implementation of the proposed approach, before the final IM is determined. We have identified a number of practical difficulties above but there may be others that require further consideration.

We trust the Commission finds these comments useful and would welcome further discussion with the Commission on any of the points raised above.

Yours sincerely



Alan Jenkins  
Chief Executive  
Electricity Networks Association