

Cross-submission

Related party transactions: Draft decision and determinations guidance

4 October 2017



Table of Contents

1	Introduction	1
2	Risk of Unintended Consequences	1
3	Ensuring Evidence-based Decisions	2
4	Weight of Evidence - Auditors' Expert Views	3
5	Setting a Realistic Transition.....	3
6	Concluding Remarks	4

1 Introduction

Aurora Energy welcomes this opportunity to cross-submit in relation to the Commerce Commission's "Related party transactions - Draft decision and determination guidance" (the draft decision), dated 30 August 2017.

No part of our cross-submission is confidential and we are happy for it to be publicly released.

If the Commission has any queries regarding our submission, please do not hesitate to contact:

Alec Findlater
General Manager Network Commercial
Aurora Energy Limited
alec.findlater@auroraenergy.co.nz
027-222-2169

2 Risk of Unintended Consequences

There seems to be general support, from all sides of the industry, for a more principles-based approach to related party transactions (RPTs). Where the general agreement ends is in relation to how onerous the regime should be, with some retailers/gentailers advocating positions that would put up barriers to efficient arrangements.¹

We agree with Mercury Energy's endorsement of "a regime for related party transactions that is simplified, clearer, and more transparent."²

We also agree with FirstGas "that the role of the regulator in this decision-making process is to ensure that structural choices and service delivery arrangements are based on business need and consumer interests, rather than being driven by regulatory rules. This means that the regulatory rules should not incentivise or dis-incentivise particular business structures."³

We share FirstGas' concern that:

"More prescriptive requirements would carry higher risks of unintended consequences ... including:

- A loss of legitimacy in tendering processes. If the Commission required all services provided by related parties to be tendered, we believe this would pose a risk to the integrity of tendering processes. Depending on how such a requirement was applied, parties competing with related parties could come to see their role as simply establishing a benchmark price for awarding the contract (sometimes referred to as becoming a "stalking horse").*
- More insourcing, with less competition and visibility of efficient costs. More prescription would also likely lead to higher compliance costs in tendering and transitioning from one service provider to another. This would tend to increase the use of insourcing by asset owners, leaving little or no competition in the market (contrary to the regulatory intent of RPT rules and disclosures)."⁴*

FirstGas' views are consistent with our submissions that the RPT rules could be a barrier or impediment to efficient related party arrangements, and that this is something the Commission should have regard to.

¹ A lot of the retailer/gentailer submissions cover old ground. This has included repetition of earlier submissions dealing with matters outside of the Commerce Commission's Part 4 remit, such as ERANZ' separation proposals and views on the definition of electricity lines services. Other than noting their generally self-serving nature, we have treated these submissions as out-of-scope, and have not responded to them.

² Mercury Energy. (2017). Input Methodologies Review Draft Decision: Related Party Transactions. 27 September 2017, p1.

³ FirstGas. (2017). Related party transactions: Draft decision and determination guidance. 27 September 2017, p3.

⁴ FirstGas. (2017). Related party transactions: Draft decision and determination guidance. 27 September 2017, p5.

3 Ensuring Evidence-based Decisions

We were disappointed with the ERANZ position that evidence of a problem isn't required to justify, not only the move to a more principles-based approach, which at least had widespread support, but also substantially more onerous RPT arrangements.

ERANZ talked about "actual behaviours" but gave no examples or evidence of behaviour to support its claims.⁵ ERANZ seems happy to merely rely on assertions about incentives and ability ("means and motive")⁶ to abuse or thwart the RPT rules.

Assuming, for a moment, that ERANZ' hypothesis was correct, it is difficult to understand why any regulated supplier would outsource any part of its operations. To do so, would reduce the scope to abuse the RPT rules. Clearly such a hypothesis does not survive the most cursory examination.

ERANZ' position that the Commission should simply rely on rumour and supposition about regulated supplier's incentives is in stark contrast with their submission on Powerco's CPP, which argues for quantified CBA to justify the proposals. In that submission, ERANZ makes it very clear that it considers the "standard way" to determine whether proposals (in the case of the Powerco CPP, additional expenditure) are "*in the long-term benefit of consumers is to apply a cost-benefit analysis (CBA).*"⁷ and that "*consultation cannot serve as an adequate substitute for the Commission undertaking a cost-benefit analysis (CBA).*"⁸ If that is a genuinely held view of ERANZ, it should also have been applied to the RPT consultation.

The FirstGas submission helpfully provides details of the kind of evidence the Commission could, and should, be seeking as part of its review of RPT arrangements. The evidence FirstGas has provided demonstrates that "*the observed costs of regulated businesses that use related parties are not systematically different to regulated businesses that do not use related parties (when adjusted for scale effects)*".⁹

This provides a strong basis for concluding that the potential abuse of the RPT rules is a theoretical problem. Even if ERANZ and retailers/gentailers are correct that regulated suppliers have incentives to abuse the RPT rules to inflate costs, there is no evidence to support for their submissions that regulated suppliers have done so.

We agree with FirstGas' observation that "*through the two consultation papers and submissions received to date, no evidence has been presented on the impact that higher levels of RPTs are having on consumers. It is unclear from the evidence presented to date whether RPTs are increasing the costs paid by consumers or the quality of service they receive, and therefore whether or not the use of RPTs is in consumers' long term interests.*"¹⁰

FirstGas points out the risk that lack of evidence creates - "*that the Commission's draft decision is not calibrated to the scale of any identified problems*" and this could mean they "*create compliance costs that outweigh any corresponding benefits.*"¹¹

⁵ ERANZ. (2017). ERANZ Submission to the Commerce Commission on the Input Methodologies Review draft decision on Related Party Transactions. 27 September 2017, p11.

⁶ ERANZ. (2017). ERANZ Submission to the Commerce Commission on the Input Methodologies Review draft decision on Related Party Transactions. 27 September 2017, p2.

⁷ ERANZ. (2017). ERANZ Submission on Powerco's Customised Price-Quality Path Proposal. 22 September 2017, paragraph 3.5, p2.

⁸ ERANZ. (2017). ERANZ Submission on Powerco's Customised Price-Quality Path Proposal. 22 September 2017, paragraph 3.16, p5.

⁹ FirstGas. (2017). Related party transactions: Draft decision and determination guidance. 27 September 2017, p6.

¹⁰ FirstGas. (2017). Related party transactions: Draft decision and determination guidance. 27 September 2017, p3.

¹¹ FirstGas. (2017). Related party transactions: Draft decision and determination guidance. 27 September 2017, p1.

4 Weight of Evidence - Auditors' Expert Views

Our last submission noted that Deloitte and PwC auditors provided feedback on problems with the complexity of the RPT rules¹², which supported the experience of regulated suppliers.

This feedback was further bolstered by expert submissions from PwC and their audit division.

We are of the view that the Commission should take particular heed of the expert views of auditors on its proposals. Auditor expert views highlight that further work is needed on the proposals to ensure that they are workable and robust.

We agree with PwC, for example, that:

*"the draft IMs and IDD need further amendment or review, to ensure application of the new rules does not result in unintended outcomes that are not consistent with the policy intent or an unreasonable compliance burden.";*¹³

*"The level of prescription in the disclosure requirements is unnecessary for the provision of meaningful supporting evidence and unduly adds compliance complexity and cost.";*¹⁴ and

*"Less prescriptive disclosures focused on the nature and extent of related party relationships and transactions will provide better information to readers.";*¹⁵

The PwC submissions include a number of constructive recommendations to address the problems with the Commission's proposals, such as *"allow[ing] for a cost based option for related parties, similar to the group consolidation methods applied under GAAP" where "Independent valuation evidence may not be obtainable.";*¹⁶

5 Setting a Realistic Transition

Our submission suggested that the Commission should not target 2018/19 for implementation, and that a transitional approach with a phased implementation may result in a more effective outcome.

It is clear, particularly from the expert views of auditors, that further work is needed in developing the new RPT rules. This could further put pressure on 2018/19 if it takes longer for the Commission to make a final decision than has been anticipated.

Our views on timing are also supported by the Orion and Unison submissions.

Orion *"suggest[ed] that given our submissions around clarity and scope that the Commission reconsider the commencement date of the new rules to allow EDBs time to review existing policies, contracts, market testing and structures. We recommend commencement from 1 April 2019.";*¹⁷

Unison similarly commented that *"The Commission proposes that the new requirements would come into force from 1 April 2018. In Unison's case, with respect to Unison's contracting business, UCSL, unless the Commission adopts Unison's proposal to continue to allow consolidation as a method of valuing UCSL's services, it would take some time to establish market rates across all categories of expenditure and to test these against benchmarks.";*¹⁸

¹² Commerce Commission. (2017 Input Methodologies Review: Related party transactions – Invitation to contribute to problem definition. 12 April 2017, paragraphs 3.23 to 3.26 and 3.32 to 3.35, p26-28.

¹³ PwC. (2017). (Group) Submission to the Commerce Commission on Input methodologies review: decision on draft related party transactions. 27 September 2017, paragraph 18, p5.

¹⁴ PwC. (2017). (Group) Submission to the Commerce Commission on Input methodologies review: decision on draft related party transactions. 27 September 2017, paragraph 13, p4.

¹⁵ PwC. (2017). (Auditor) Submission to the Commerce Commission on Input methodologies review: Related party transactions –draft decision. 27 September 2017, paragraph 13, p4.

¹⁶ PwC. (2017). (Group) Submission to the Commerce Commission on Input methodologies review: decision on draft related party transactions. 27 September 2017, paragraph 10, p3.

¹⁷ Orion. (2017). Submission on input methodologies review draft decision- related party transactions. 20 September 2017, paragraph 20, page 5.

¹⁸ Unison. (2017). VALUATION OF RELATED PARTY TRANSACTIONS. 27 September 2017, paragraph f.d., p4.

6 Concluding Remarks

We would be disappointed if the Commission made final decisions on the RPT rules based on subjective judgements about the incentives and ability of regulated suppliers to abuse or thwart the RPT rules, particularly given the precedent given by decisions on the WACC percentile.

A more rounded consideration, that acknowledged the problems regulated suppliers face in applying the existing RPT rules, would likely still mean adoption of a more principles-based set of RPT rules. No one is really arguing against that. It would also mean some of the compliance issues with the proposed rules would also be addressed.

Aurora Energy, various other regulated suppliers, and expert auditors have all raised concerns, for example, about how the definition of “related party” (limb (b)) sits with GAAP¹⁹, and about the need for ‘safe harbour’ provisions; e.g., PwC has recommended “allow[ing] for a cost based option for related parties, similar to the group consolidation methods applied under GAAP” where “Independent valuation evidence may not be obtainable.”²⁰

We reiterate that any trading division or subsidiary of an EDB that reports RPTs on a consolidated basis (i.e., similar to ID clause 2.3.6(1)(a) and IM clause 2.2.11(5)(g)) should be excluded from any more onerous disclosure, on the basis that the outcome is not inconsistent with those expected in a workably competitive market.

Aurora Energy agrees with FirstGas that “Regulation should not distort choices on business structure”.²¹

If the RPT rules create roadblocks against use of RPT arrangements, it will be distorting choices and thwarting the ability of regulated suppliers to improve efficiency, and for those efficiency gains to be shared with consumers. This would run counter to the Commission’s intent that “We do not seek to prevent regulated suppliers from using related parties to provide services, as they can be efficient, securing economies of scale and scope.”²²

¹⁹ We agree with PwC that “The change to part (b) of the definition extends the scope of what is a related party beyond what we believe the Commission intended. It is now unclear which parties and transactions are intended to be captured by the definition, which raises the risk that the rules may be misinterpreted or misapplied. Further, it causes misalignment with the incorporated auditing standards, which use only part (a) of the definition”. PwC. (2017). (Group) Submission to the Commerce Commission on Input methodologies review: decision on r draft elated party transactions. 27 September 2017, paragraph 7, p3.

²⁰ PwC. (2017). (Group) Submission to the Commerce Commission on Input methodologies review: decision on r draft elated party transactions. 27 September 2017, paragraph 10, p3.

²¹ FirstGas. (2017). Related party transactions: Draft decision and determination guidance. 27 September 2017, p2.

²² Commerce Commission. (2017). Related party transactions: Draft decision and determination guidance. 30 August 2017, paragraph X8, p9.