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# Submission

Related party transactions: Draft decision and determinations guidance

**27 September 2017**



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# 1 Introduction

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Aurora Energy welcomes this opportunity to comment on the Commerce Commission's "*Related party transactions - Draft decision and determination guidance*" (the draft decision) dated 30 August 2017.

No part of our 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:

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## 2 Opening Comments

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Aurora Energy supports the proposal, set out in the draft decision, to apply a principles-based approach to setting the value of related party transactions (RPTs).

A number of submissions, including our own, have detailed problems with the current rules-based approach, and some of the individual options for determining RPT value. Resolving these issues would be a positive step.

We agree that EDBs should be able to demonstrate that input prices set through RPTs are reasonable<sup>1</sup>. Information Disclosure can be used to make RPT arrangements and terms transparent, just as occurs for distribution pricing methodologies and asset management planning, etc.

We also agree that an 'arm's-length transaction' provides a suitable test or benchmark for determining whether input prices set through RPTs are reasonable, and consider that the use of the definition in auditing standard ISA (NZ) 550 is appropriate<sup>2</sup>.

Our comments on the Commission's draft decision are caveated by questions about whether the Commission has, as yet, sufficiently considered whether RPT rules (current and proposed) can be a barrier or impediment to efficient related party arrangements, and whether there is evidence of the current arrangements being abused. We want the Commission's decision-making to be soundly evidence-based.

We are also concerned that, since the problem definition is based almost entirely on risk and unsupported by anything stronger than circumstantial evidence, aspects of the proposal go further than required and represent a disproportionate response.

## 3 Getting the Problem Definition Right

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We agree with Alpine Energy that the problem definition would be better described as "*being that EDBs are struggling to demonstrate arm's-length transactions because the options as currently written are overly complex, inconsistent and difficult to apply.*"<sup>3</sup> The ENA made similar comment that the problem is that "*The current practical application of the related party provisions could be improved to better align with the policy intent.*"<sup>4</sup>

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<sup>1</sup> Commerce Commission. (2017). Related party transactions: Draft decision and determination guidance. 30 August 2017, paragraph X8, p9.

<sup>2</sup> Commerce Commission. (2017). Related party transactions: Draft decision and determination guidance. 30 August 2017, paragraph X9, p9.

<sup>3</sup> Alpine Energy. (2017). Submission to the Commerce Commission on Input methodologies review: Related party transactions – invitation to contribute to problem definition. 17 May 2017, paragraph 29, p5.

<sup>4</sup> ENA. (2017). Input Methodologies review. Related party transactions – problem definition. 17 May 2017, paragraph 14, p6.

There are problems with the existing RPT arrangements:

- Our previous submission raised the potential for the RPT rules to impede the efficient use of related parties and/or result in under-payment in RPTs<sup>5</sup>;
- Deloitte and PwC auditors provided feedback on problems with the complexity of the RPT rules<sup>6</sup>; and
- Each of the EDB submissions, Wellington Electricity excepted, outlined problems and difficulties with applying the existing rules. Powerco provided a succinct and accurate summary:

*“Aspects of the current design are difficult to interpret and therefore implement. The difficulties we have experienced appear to be common to suppliers as evidenced in the Commission’s findings. We have found the complexity of the rules and inconsistency between IMs and IDD particularly troublesome.”<sup>7</sup>*

We feel that this a key element of the problem definition development that warrants more attention. It may well support a move away from the current rules-based approach to principle-based options, as the Commission proposes, but not necessarily to a tightening of the RPT requirements.

Care is needed to ensure that overly-prescriptive rules for how RPT prices are set are not replaced by overly-prescriptive rules for how to demonstrate RPT prices are set on an arm’s-length basis.

We agree with the Commission that the *“related party rules must be workable and applicable in a wide range of supplier circumstances.”*<sup>8</sup> Similarly, also, we agree with PwC that the design of a principles-based regime should avoid prescription and complexity.<sup>9</sup>

It is unclear, for example, whether the proposed new RPT rules need to extend beyond a requirement to demonstrate that transactions are equivalent to arm’s-length transactions, to also include specific details requiring application of *“competitive price signals”* or *“benchmarking of transaction values”*.<sup>10</sup> We query how readily firms in workably competitive markets could demonstrate they are operating on an arm’s-length basis using these specific tests.

## 4 Ensuring Evidence-based Decisions

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It is extraordinary that, despite the lack of evidence of EDBs misusing the current RPT settings, some incumbent gentailers are suggesting structural solutions are needed. We think it is telling that no evidence has been provided of *“use [of] an unregulated related party to increase overall profits by charging greater than arm’s-length prices to the regulated supplier.”*<sup>11</sup>

It is not as if RPTs are a new issue. While there have been attempts to dress the topic up as an emerging technology issue, the reality is that EDBs have engaged in unregulated/related party activities long before energy technology become topic de jour.

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<sup>5</sup> Aurora Energy. (2017). Submission, Input Methodologies Review: Related party transactions – Invitation to contribute to problem definition. 17 May 2017, section 6, p4.

<sup>6</sup> 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.

<sup>7</sup> Powerco. (2017). Submission to the Commerce Commission on Input methodologies review: Related party transactions – invitation to contribute to problem definition, 17 May 2017, p 3.

<sup>8</sup> Commerce Commission. (2017). Related party transactions: Draft decision and determination guidance. 30 August 2017, paragraph 3.4, p28.

<sup>9</sup> PwC. (2017). Submission to the Commerce Commission on Input methodologies review: Related party transactions – invitation to contribute to problem definition. 17 May 2017, paragraph 6, p3.

<sup>10</sup> Commerce Commission. (2017). Related party transactions: Draft decision and determination guidance. 30 August 2017, paragraph X12.2, p10.

<sup>11</sup> Commerce Commission. (2017). Related party transactions: Draft decision and determination guidance. 30 August 2017, paragraph X7.1, p8.

We are disappointed that, while the Commission has acknowledged the concern raised by submitters such as ourselves, the problem definition lacks an evidential basis. The Commission has yet to adequately address the concern that:

*"we are yet to see evidence of related parties supplying inputs at excessive prices under the current RPT rules. Aurora considers that evidence of over-payments is needed to justify tightening of the RPT rules" but has not adequately addressed it.*"<sup>12</sup>

The Commission's response is simply that *"it is correct that we are unable to conclude whether a large share of the related party transactions meet the arm's-length standard."*<sup>13</sup> The Commission's specification of the problem is heavily qualified, and hypothetical, with use of terms such as 'potential', 'risk', and that it is seeing things which 'points' to there being a problem.

We share Alpine Energy's concern that *"the Commission appears to be inferring that EDBs have been actively behaving in a manner that requires further rules be put into place without providing any evidence that any such behaviour has been or is occurring."*<sup>14</sup>

It is important that the Commission's decision-making is evidence-based, and limits reliance on subjective judgement. This point was strongly made by the High Court in the IM Merit Appeal judgement.<sup>15</sup> Although *obiter dictum*, we do not think that the Court's guidance should be lightly cast aside.

Absent any evidence of EDBs abusing the current RPT settings, the Commission does not have a sound basis on which to determine that the RPT rules should be tightened. At most, the Commission could conclude that it needs to investigate the matter more, or make changes to the Information Disclosure requirements to help improve the transparency of RPTs. The policy foundations for the draft decision are metaphorically built on sand, rather than rock.

## 5 Definition of Related Party

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Despite that a principal objective of the draft decision was to remedy some of the definitional deficiencies of the current RPT rules, we are concerned that the proposed definition of 'related party' creates deficiencies. The Commission proposes that 'related party' should be defined as:

*"(a) a person that is related to the regulated business, where the regulated business is considered as the 'reporting entity', as specified in the definition of 'related party' in NZ IAS 24; or*

*(b) any part, branch or division of the regulated business that does not supply regulated services."*<sup>16</sup>

We consider that limb (a) of the proposed definition is appropriate, and that alignment with arrangements outside of the regulatory construct is preferred, where possible. We consider, however, that limb (b) is problematic, as it would encompass self-performed functions within the EDB that are normally recognised at cost under GAAP. We are, in fact, unclear as to what problem that this limb of the definition seeks to solve.

### 5.1 Safe Harbour

In addition to our view that self-performing divisions of the EDB should be excluded from the definition of related party, we also consider that there are circumstances that warrant 'safe harbour' provisions. We consider 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

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<sup>12</sup> Aurora Energy. (2017). Input Methodologies Review: Related party transactions – Invitation to contribute to problem definition. 17 May 2017, section 2, p1.

<sup>13</sup> Commerce Commission. (2017). Related party transactions: Draft decision and determination guidance. 30 August 2017, paragraph 3.18, p37.

<sup>14</sup> Alpine Energy. (2017). Submission to the Commerce Commission on Input methodologies review: Related party transactions – invitation to contribute to problem definition. 17 May 2017, paragraph 27, p5.

<sup>15</sup> Wellington International Airport Ltd and others v Commerce Commission [2013] NZHC 3289. 13 December 2013.

<sup>16</sup> Commerce Commission. (2017). Related party transactions: Draft decision and determination guidance. 30 August 2017, table 4.3, p55.

onerous disclosure, on the basis that the outcome is not inconsistent with those expected in a workably competitive market. We doubt that there is any substantive argument that could be made that such an arrangement would be contrary to the Part 4 purpose statement.

## 6 Disclosure by Capex and Opex Category

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The draft decision requires a number of additional disclosures and audit assurances by opex and capex category. For example:

*“for each operational expenditure category or capital expenditure category amounting to at least 10% of the EDB’s total related party expenditure in the disclosure year, a representative example from the disclosure year of how the current policy for the procurement of assets or goods or services from a related party is applied in practice.”<sup>17</sup>*

and

*“examples disclosed of market testing of transaction terms are representative of the methodology applied by the supplier of the regulated service in establishing the terms for each expenditure category.”<sup>18</sup>*

This latter paragraph, in particular, reveals a disconnect between the regulatory construct and ‘real-world’ practice. Engagement of a service provider, whether a related or unrelated party, is a procurement exercise that does not consider the expenditure category that the work is ultimately allocated to for regulatory reporting purposes. EDBs do not generally set independent procurement terms for each expenditure category, although there are likely to be some differences in terms between capital expenditure, fault response, planned maintenance, and vegetation management due to the underlying nature of the activity. We recommend that the Commission reduce the categorisation to these broad categories. In our view, full disaggregation to the opex and apex expenditure categories will achieve little other than to further burden EDBs with unjustifiable compliance costs.

## 7 Emerging Technologies Revisited

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We note reference to the lobbying by gentailers, ERANZ, and others, which amounts to an attempt by those organisations to re-open arguments made around emerging technology. We have some concerns that this lobbying may have influenced a disproportionate response that goes beyond the transparency and efficacy of RPTs.

The Commission has proposed that EDBs should disclose a map of possible network constraints where an opex or significant capex solution is likely. The trigger for this additional disclosure is the reporting, by the EDB, of any RPT (without threshold) in any expenditure category in the previous disclosure year; the logic of which eludes us.

Network constraints and RPTs are unrelated. The historic existence of a RPT has absolutely no bearing on whether a non-network solution is available or whether it is the most efficient (or prudent) option open to the EDB. We would further note that some non-network solutions, like using customer batteries, are for most New Zealand EDBs in an immature state from the perspective of sufficient aggregated capacity, and commercial terms for ensuring that the non-network solution provider adequately underwrites the EDB’s regulatory and contractual service obligations.

We note that the Commission had previously stated, with regard to emerging technology, that there is *“No decisive evidence that large scale changes are needed to better promote long-term benefit of consumers of the regulated service provided that costs are allocated correctly.”<sup>19</sup>* We are not aware of the Commission having resiled from that view.

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<sup>17</sup> Commerce Commission. (2017). [DRAFT] Electricity Distribution Information Disclosure Amendments Determination (No.2) 2017. Clause 2.3.9(5), p44.

<sup>18</sup> Commerce Commission. (2017). Related party transactions: Draft decision and determination guidance. 30 August 2017, paragraph 4.30.8, p48.

<sup>19</sup> Commerce Commission. (2016). Input Methodologies Review: Overview of Decisions – analyst briefing. 20 December 2016.

## 8 Setting a Realistic Transition

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The RPT draft decision would impose substantially different and new requirements on EDBs.

This is a material matter. The Commission has noted that RPTs make up between 30-65%, or 65% and more, of the total opex or capex of a significant number of EDBs.

Given the nature of the new requirements, and the difficulty and complexity involved in determining how to demonstrate that RPTs are at arm's-length, we question whether the new requirements can be successfully implemented for the 2018/19 disclosure year. We consider that a transitional approach, with a phased implementation, may result in a more effective outcome.

## 9 Concluding Remarks

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We welcome the Commission's statement 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"*<sup>20</sup>. The statement could be expressed in more positive terms though; e.g., the Commission wants to encourage or promote the use of related parties where this is efficient.

The Commission's focus has been on the 'potential' for abuse of the RPT rules, while neglecting the possibility that the rules are a barrier to efficient RPT arrangements. We share PwC's concern, which seem to have been realised with the latest consultation, that *"if the focus of the review becomes the prevention of perceived or potential bad behaviour, it risks losing sight of the proper objective of the review, which is to produce workable and effective provisions for the identification of arm's-length prices."*<sup>21</sup>

A prospect that the Commission does not appear to have considered is that, if a shift to a more principles-based set of arrangements is successful in ensuring RPTs are undertaken on arm's-length equivalent terms, there is a prospect for the price for some RPTs to increase. Under-charging could be an issue, or just as much an issue, as potential over-payment.

The marker for success of any change to the RPT rules isn't whether the use of related parties increases or decreases, or whether the payments go up or down, but whether the RPT rules enable efficient use of related parties on a basis that is equivalent to arm's-length terms. One risk, if the Commission doesn't get the regulatory settings right, is that the new RPT rules could have a chilling effect on RPTs, even where they are the most efficient arrangements.

While the Commission does not intend to be preventive, it should be recognised that unduly complex and difficult compliance requirements can become coercive, resulting in unintended consequences; for example, EDBs abandoning efficient related party arrangements for 'the easier road'.

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<sup>20</sup> Commerce Commission. (2017). Related party transactions: Draft decision and determination guidance. 30 August 2017, paragraph X8, p9.

<sup>21</sup> PwC. (2017). Submission to the Commerce Commission on Input methodologies review: Related party transactions – invitation to contribute to problem definition. 17 May 2017, paragraph 10, p3.