Submission to the Commerce Commission

on

Input methodologies review: draft decision on related party transactions

Made on behalf of 17 Electricity Distribution Businesses

PwC submission on behalf of a group of 17 electricity distributors

27 September 2017

Introduction

Overview

1. This paper forms our submission on the Commerce Commission's (Commission) draft decision and determinations guidance for related party transactions, released on 30 August 2017 (the draft decision). This submission has been prepared by PricewaterhouseCoopers (PwC) on behalf of the following 17 Electricity Distribution Businesses (EDBs):

    - Alpine Energy Limited
    - Aurora Energy Limited
    - EA Networks
    - Eastland Network Limited
    - Electricity Invercargill Limited
    - Electra Limited
    - Marlborough Lines Limited
    - Nelson Electricity Limited
    - Network Tasman Limited
    - Network Waitaki Limited
    - Northpower Limited
    - OtagoNet Joint Venture
    - The Lines Company Limited
    - The Power Company Limited
    - Top Energy Limited
    - Waipa Networks Limited
    - Westpower Limited.

2. Together these businesses supply 25% of electricity consumers, maintain 40% of total distribution network length and service 63% of the total network supply area in New Zealand. They account for around 60% of related party operational expenditure and around 68% of related party capital expenditure.[1] They include both consumer owned and non-consumer owned businesses, and urban and rural networks located in both the North and South Islands.

3. We trust this submission provides useful input to your consultation on the draft decision. We would be happy to answer any questions you may have regarding this submission.

4. The primary contact for this submission is:

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[1] EDB Information disclosures for disclosure year ending 31 March 2016

Summary

We welcome the move to a principles based approach

5. The EDBs which support this submission welcome the Commission's decision to introduce a principles based approach to related party transactions, supported and underpinned by written guidance and the incorporation by reference of accounting and auditing standards.

6. This approach, if implemented well, will reduce the complexity of the regime, which was one of the original aims of the IM review process.

However, there are issues with the definition of "related party"

7. Although many issues concerning unclear or confusing definitions have fallen away with the introduction of a principles-based regime, the proposed amendment to the definition of related party is problematic. 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.

8. The EDBs which support this submission believe that part (b) of the definition is not necessary to meet the policy intent. Appropriate allocation of the costs of supplying regulated and non-regulated services supplied by internal divisions of EDBs is achieved under the cost allocation methodology. Therefore, there is no need for a related party transaction regime to sit across internal divisions of an EDB.

9. The EDBs which support this submission submit that part (b) of the related party definition should be deleted. We consider that the part (a) limb is sufficient to fully meet the policy intent. This will avoid undue complexity, unnecessary compliance cost and conflict with the cost allocation IM. It will also avoid undermining the quality of scrutiny offered by the incorporation of the auditing standards.

Independent valuation evidence may not be obtainable

10. We consider that it may be useful for the Commission to allow for a cost based option for related parties, similar to the group consolidation methods applied under GAAP. This would have the practical effect of treating the related party as an internal division after elimination of any inter-company profit margins. In these circumstances, the costs, assets and revenues associated with any non-regulated services supplied by the related party would be excluded for regulatory reporting purposes by applying the cost allocation IM.

11. This would be a cost effective compliance option, which would also be expected to result in costs below arm's-length prices due to the elimination of any profits. It is also consistent with GAAP which assists with audit and transparency.

The extent of the disclosure requirements will increase compliance costs

12. The EDBs which support this submission consider that the disclosure and assurance requirements are disproportionate to the problem being addressed. The policy intent set out by the Commission is to ensure that related party transactions are valued on no more than an arm's-length basis and that efficiencies are shared with consumers. The problem that was identified was that the lack of clarity in the current rules meant that this might not be happening (but did not go so far as to state that it had not been happening in practice).

13. While we recognise the need for meaningful and transparent disclosure in a principles-based regime, the EDBs which support this submission believe that the proposed disclosures are not fully justified. Against the context that the problem identified is only a risk and not an established issue, we consider the requirements are unduly onerous and excessive. Our key concerns are that:

    - The level of prescription in the disclosure requirements is unnecessary for the provision of meaningful supporting evidence and unduly adds compliance complexity and cost. We suggest some of the proposed disclosure requirements could more usefully be included as guidance, thereby providing more flexibility for EDBs in how they respond to each overarching information requirement.

    - The requirements are too granular in specifying disclosures at the opex and capex category level, and therefore they will not adequately reflect the scope and scale of related party arrangements for a particular EDB. In addition, these expenditure categories are a regulatory construct, and therefore they are unlikely to reflect how each EDB manages its related party services. Further, supporting evidence relating to one capex or opex category may be able to be relied on for another category, where the procurement processes and basis of charging are the same, and where there is little external market evidence available.

    - The proposal to require asset management information about network constraints and future network investment is not necessary to provide transparency about related party transactions. This is a wider asset management issue which is not confined to those with related party service providers. These additional disclosures should not be included in this decision because they fall outside the scope of the problem being addressed.

    - The proposal to require an independent report with additional evidence for those with more material related party transactions is not required. It places insufficient weight on the evidence already provided, and the assurances provided by the auditor and the certifications by directors. If an auditor is unable to form a view, the Commission is able to seek further evidence.

14. These points are explained more fully in the body of this submission.

15. The EDBs which support this submission therefore recommend that the Commission:

    - Reduce the amount of prescription in the draft ID determination by:

        i. Not prescribing the form in which certain information is to be disclosed; and

        ii. Reducing the amount of information to be disclosed by removing requirements that do not meaningfully contribute to an assessment of whether transactions are valued at arm's-length or a related party relationship;

    - Remove any requirement for an independent assessor.

A principles based regime is the right approach

Support for the principles based regime

16. The EDBs which support this submission welcome the move to a principles-based approach for related party transactions. Supported by proportional disclosure requirements and scrutiny under standard auditing rules, this approach should reduce complexity and enable the regime to be applied by EDBs, their directors and auditors more efficiently and with more certainty than was possible under the existing rules.

17. However, the EDBs which support this submission believe there are some elements of the draft decision that will increase uncertainty, complexity and impose compliance costs which are disproportionate to the policy intent, potentially to the extent that they cancel out the improvements achieved by the adoption of a principles based approach.

18. Therefore, although the overall approach of the amended IMs is supported, the EDBs which support this submission submit that parts of 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.

19. We address these matters in the remainder of this submission, and also attach marked-up versions of the draft IM and ID determinations to reflect the recommendations made in our submission.

The definition of "related parties" should be amended

The definition of "related party" undermines the strength of the principles based regime

20. The strength of a principles based regime is the clarity and simplicity it provides, including a reduction in the risk that the policy intent is not achieved through parties misapplying a confusing set of rules. However, the proposed definition of 'related party' risks undermines the effectiveness of the new rules by introducing confusion as to which 'parties' or transactions are intended to be captured.

21. The Commission's policy intent for related party transactions is set out at paragraph 2.39 of the draft decision:

> *2.39 Our policy intent is therefore to ensure that the value of a good or service acquired by the regulated service from a related party, or the value received from the sale or supply by the regulated service of an asset or service to a related party, is disclosed on the basis that:*
>
> *2.39.1 each related party transaction is valued as if it had the terms of an arm's-length transaction; and*
>
> *2.39.2 the value of a related party transaction is based on an objective and independent measure.*

22. The proposed definition of 'related party' unnecessarily departs from the GAAP definition of related party, and consequently captures services which are internal to the EDB. This extends beyond the policy intent, ignores the role of the cost allocation IM and accordingly introduces an unreasonable compliance burden.

23. It is also worth noting that the Commission proposes (and we support) incorporating into the IM by reference accounting and auditing standards, to align requirements between the IM and those standards and improve compliance efficiency. However, by including the second limb to the definition

of 'related party', the IM creates a direct misalignment between the related party rules and these standards, which use only the first limb of the definition.

The expanded definition is not necessary to further the Commission's policy intent

24. We submit that transactions involving a division of the regulated business should not be captured by the related party provisions.

25. Where an internal division of the EDB also provides services to external parties, the costs associated with providing those external services are excluded from the regulatory cost base (via the cost allocation IM). Any associated revenues are also excluded, as they do not meet the definition of regulatory income. The existence of external customers does not create a related party relationship between the EDB and an internal division.

26. In addition, the explanation at clause 4.48 of the draft decision suggests that the related party definition may capture internal divisions of the EDB, where that division does not provide services to external parties. This may be unintentional, but in any event it needs to be rectified, as this is not a related party relationship. The draft decision appears to (either intentionally or unintentionally) extend an arm's length transaction value test into the internal operations of the EDB which is not consistent with the policy intent.

27. Regulated businesses are already both required and incentivised to continually seek efficiencies and share these with their consumers within the broader Part 4 context, including the price cap, IRIS mechanisms and also via their consumer ownership structures. The cost allocation IM also ensures that costs associated with non-regulated services are not included in the regulatory cost base. We also note that the recent changes to the cost allocation IM are expected to result in more shared costs being allocated to non-regulated services.

Recommendations

28. The EDBs which support this submission recommend that part (b) of the definition of 'related party' is deleted. This will align with the accounting standards and reasonably address the policy intent which is whether distributors are transacting with their related parties at prices which do not exceed those that would be determined on an arm's-length basis.

29. We submit that the related party rules are not the appropriate mechanism for the Commission to test the efficiency of the internal operations of the distributor. Further the cost allocation rules ensure costs which are not associated with the regulated service are not included in the regulatory cost base.

Valuation methods

30. It is proposed that the methods for valuing related party transactions are determined from independent and objective evidence consistent with arm's-length principles, or actual transaction value where lower. We support this approach. We note however that there may be circumstances where it is not possible to obtain suitable independent and objective evidence for certain services.

31. In the next section of this submission we propose that more flexibility is permitted in the types of evidence which may be used to demonstrate arm's-length values, including extrapolating between services, under certain circumstances.

32. However, we also consider that it may be useful for the Commission to allow for a cost based option for related parties, similar to the group consolidation methods applied under GAAP. This would have the practical effect of treating the related party as an internal division after elimination of any inter-company profit margins. In these circumstances, the costs, assets and revenues associated with any non-regulated services supplied by the related party would be excluded for regulatory reporting purposes by applying the cost allocation IM.

33. This would be a cost effective compliance option, which would also be expected to result in costs below arm's-length prices due to the elimination of any profits. It is also consistent with GAAP which assists with audit and transparency.

Recommendation

34. That the Commission allow for a cost based option for valuing related party transactions, similar to the group consolidation methods applied under GAAP.

The disclosure requirements are disproportionate

Compliance requirements should be proportionate to the problem and within the context of the Part 4 regime

35. The EDBs which support this submission acknowledge that a principles-based approach to related party transactions will involve disclosure of evidence to demonstrate compliance with the principles. We agree that it is important that related party transactions are transparent and can be demonstrated by evidence to have been conducted on arm's-length terms.

36. However, it is important that compliance requirements are proportionate to the problem they are addressing. The EDBs which support this submission believe that the proposed disclosure requirements are disproportionate to the problem and, particularly in the context of the wider Part 4 regime, a less stringent compliance requirement would be sufficient to demonstrate that related party transactions are not resulting in detrimental outcomes for consumers.

37. The proposed disclosure requirements are significantly more prescriptive and far reaching than the evidence required in support of related party transactions which may be included in a CPP application. The related party information requirements in the CPP IMs were reviewed last year, and revised with the objective of being more fit for purpose, and to remove an excessive compliance burden. We encourage the Commission to review the CPP IM information requirements (contained in Schedule D), which we consider provides a more practicable, less prescriptive approach to disclosure of information about related party transactions.

38. In addition, some of the disclosure requirements proposed are not consistent with the policy objective. This is because they propose information which is not required to address the arm's-length nature of related party transactions, and instead reaches across into the wider asset management practise of the EDB. The EDBs which support this submission suggest that these proposed disclosures are not necessary to address the problem, and therefore should be excluded from the related party transaction disclosure requirements. Further the inclusion of wider asset management disclosure requirements within the related party rules adds unnecessary cost and complexity to the IMs and the IDDs, contrary to the objective of reducing cost and complexity of these rules.

The amount of information required to be disclosed is unnecessary and overly prescriptive

39. The EDBs which support this submission agree that it will be important for them to disclose, in relation to any related party transactions:

    - Which related parties they have transacted with and their relationship with them;
    - Their processes for procuring related party services and how these are applied;
    - The value of transactions, how they have been established, and whether they are consistent with the arm's-length principles;
    - An assurance report which verifies the evidence supporting these disclosures;
    - A Director's certificate which confirms the above.

40. In forming the audit opinion, the auditor will seek access to additional evidence in order to form its view, however it should not be necessary for this evidence to be published. The Commission should be

prepared to rely on the audit report and director certification. The current proposals require duplicated compliance, as in addition to the auditors and Directors seeking sufficient supporting evidence for arm's-length principles, the disclosure of substantial evidence is also required. We suggest that the requirements remove this duplication by either:

- Removing the requirement for the audit report or
- Removing the requirement to disclose much of the prescribed supporting evidence suggested, on the basis that the auditor will seek appropriate evidence when forming its view.

41. The EDBs which support this submission consider that the proposed disclosure requirements are too prescriptive and therefore will impose unnecessary compliance cost. We suggest that some of the requirements which are currently proposed could more usefully be included in the guidance which the Commission is proposing to make available. This will allow EDBs some flexibility in how best to respond to the requirements in a manner which suits their own particular related party relationships.

42. In particular, we recommend:

- For the IMs and IDD – the references to the guidance notes are not included, and instead all guidance is provided in the papers which support the final decision. This is current practice and we consider it is confusing to include guidance notes for some components of the IMs and ID in the determinations themselves, but not references to all guidance. In addition, referring to guidance which may change over time appears inconsistent with the certainty objectives of the IMs. Notwithstanding this view, we support including reference to the appropriate accounting standards for related party transactions in the IMs, as these form the basis of the rules on which the related party requirements are determined.
- Disclosure of evidence supporting related party transactions for every capex and opex category which exceed 10% of the value of transactions is removed. We submit this is unnecessary prescription which adds undue compliance cost. The EDBs which support this submission consider it is more reasonable to allow the EDB and the auditor to determine the appropriate evidence required to ascertain that related party transaction values do not exceed arm's-length prices. Auditors use appropriate methodologies to ensure adequate coverage during their testing to be able to make conclusions on all material matters.
- In this respect we note that it may be entirely reasonable that evidence that supports one category of transaction is also valid for another. This will be important because:
    i. These capex and opex categories are a regulatory construct, derived for standardised regulatory reporting purposes. They do not reflect the way in which EDBs establish contracts for services with related parties, and contracts for related party services are likely to span multiple 'regulatory cost categories'. Further it is unlikely that EDBs will have recorded the value of related party transactions using these metrics.
    ii. It may be more difficult to obtain independent benchmarks for some expenditure categories than others, particularly where there is little market competition available. However, the procurement practices and basis for charging may be similar for multiple services. Therefore, the evidence for one service may be able to be extrapolated to other services. This would be an effective way to demonstrate compliance with arm's-length principles using independent and objective evidence, where evidence for specific expenditure categories is unable to be acquired in a cost effective manner.
- Immaterial transactions are excluded from the more detailed aspects of the disclosure requirements.

- Remove the requirement in clause 2.3.9 (1) to provide a diagram of the related party relationships. We suggest that an EDB may choose to disclose a diagram to explain the relationships but should not be required to present this information in this form. By contrast, Schedule D, part D12 (1) provides that for a CPP proposal, parties must:

  > *Identify and describe all related parties in respect of whom costs are disclosed for the last disclosure year of the current period, and relationships with those parties.*

  This is an aspect of the proposals which could usefully be included in guidance, rather than prescribed.

- Remove subclauses a) to d) of clause 2.3.9 (2) regarding application of procurement policies and include these requirements in the guidance documents. This will enable each EDB to describe their procurement approaches in a way that is logical to their particular policies. In addition, the EDBs which support this submission are concerned that the information proposed may include commercially sensitive information. We suggest that more flexibility in this requirement will enable disclosures which adequately describe how the policy is applied in practice, without compromising commercial relationships.

- Remove subclauses a) and b) from clause 2.3.9 (3) regarding referral of consumers to related parties, and include these requirements in guidance, as above.

- Delete the requirements in clauses 2.3.10 and 2.3.11 for network maps showing anticipated network expenditure and network constraints as this goes beyond the policy intent.

  i. Network constraints are not dependent on the existence of related party transactions, they are a wider asset management consideration, and therefore they should fall outside of the scope of this consultation. The proposed clauses 2.3.10(3) and (4) appear to be directly aimed at answering submissions concerning the use of batteries to address network constraints, which is not relevant to the related party transaction problem definition. We do not consider that it is appropriate to include it here and submit that it should be removed.

  ii. The location of possible related party work within a network does not appear to be critical information in achieving the policy intent, particularly as most networks in New Zealand have relatively small footprints, and those which are larger tend to rely less on related party service providers, given their scale supports more competition.

  iii. We note that the CPP information requirements only require the disclosure of expected future related party transactions (schedule D, part D12 (3)(a)) and therefore we consider that if future transactions are to be disclosed, they should be limited to those future transactions the EDB reasonably anticipates will be carried out by a related party.

The requirement for an independent assessor will increase compliance costs

43. The EDBs which support this submission believe that the requirement for an independent assessor in the case of a qualified audit report or where related party transactions exceed 65% of capex or opex is an unnecessary additional layer of scrutiny. We consider the requirement unduly increases compliance costs.

44. It is not clear why the threshold was set at 65%, and the Commission's own information graphic shows this threshold will result in nearly half of all EDBs providing an independent assessor report.

45. The use by regulated suppliers of related parties can be a significant element in delivering efficiencies to consumers. It is important that EDBs make decisions about whether to use related parties for the right reasons – i.e. efficient delivery of electricity lines services to consumers – and not because of how it might affect their compliance burden.

46. The increased audit requirements for related party transactions in clause 2.8.1(2) will already result in increased compliance costs, which we accept as being necessary to improve transparency, and which will be somewhat off-set by the reduced complexity offered by the principles-based approach to valuation.

47. The EDBs which support this submission consider that increased independent audit scrutiny, together with Directors' certification and Commission scrutiny of the information to be disclosed, will be sufficient in the majority of cases to satisfy the Commission that the policy intent is being met. In cases where the Commission feels additional scrutiny is required, it could request additional information and engage an independent assessor, similar to the approach taken in assessing forecast expenditure for the default price path. This option is also available to the Commission where an auditor is unable to form a view on some aspects of the requirements.

Recommendations

48. The EDBs which support this submission recommend that the Commission:

- Reduce the amount of prescription in the draft ID determination by:
    i. Not prescribing the form in which certain information is to be disclosed; and
    ii. Reducing the amount of information to be disclosed by removing requirements that do not meaningfully contribute to an assessment of whether transactions are valued at arm's-length;
- Remove any requirement for an independent assessor.