



**ERANZ CROSS-SUBMISSION  
TO THE COMMERCE COMMISSION  
ON  
RELATED PARTY TRANSACTIONS**

**4 OCTOBER 2017**

## Introduction

The Electricity Retailers Association of New Zealand (ERANZ) welcomes the opportunity to provide this cross-submission on the Commerce Commission's (the Commission) Draft Decision Paper on Related Party Transactions.

ERANZ makes this cross-submission in light of the submissions made in respect of the Commission's review of related party transaction rules (the Draft Decision).<sup>1</sup> The Commission is responding to accepted problems with the complexity and ambiguity of the extant rules and shortcomings in the level of transparency provided by the information disclosure requirements.

First Gas have summarised the current situation:

*"The submissions received on the Problem Definition paper all agree that there are issues with the interpretation and application of the RPT rules, and inconsistencies in how RPTs are treated across Information Disclosure (ID) and the Input Methodologies (IMs). With the large number of disclosure options available for both opex and capex, it is also clear that not all of these options are providing the level of transparency sought by consumers or the Commission."*<sup>2</sup>

The Commission's Draft Decision proposes to simplify the valuation requirements by replacing a number of specific options with a general valuation rule. Under this approach, regulated suppliers will have flexibility in how they establish that related party transactions do not exceed an arm's-length price. In response to this increased flexibility in valuation approach there is a corresponding increase in disclosure requirements to improve transparency.

The submissions are largely supportive of the introduction of a principle-based approach for valuing related party transactions, despite some residual reservations about the problem definition. The specific definition of related party (and related party transactions) is seen as an issue and there are concerns that the weight of additional disclosures may outweigh the benefits of additional transparency or, at least, require that regulated suppliers are afforded time to adjust their businesses before the requirements are introduced. ERANZ provides its views on these matters below.

## Problem definition and evidence of harm

ERANZ reiterates its view that the problem is best characterised, based on the observations of the Commission, as being an increasing exposure to risk of consumer harm, in part as a result of increasing reliance by regulated suppliers on related party transactions and also due to the recognised deficiencies in the extant rules. In ERANZ's view arguments about the strength of 'evidence of harm' are a red herring.

The overarching and essential objective of the regulatory regime is that consumers of regulated services pay an efficient price for the service they demand. A corollary of this objective is that the regulated supplier's input costs are efficient. It is also necessary that the regulatory rules, put in place to ensure this is achieved, must avoid imposing an undue regulatory burden as the cost of regulation ultimately falls on the consumer.

The matter at hand is the *potential* for the use of Related Parties to cause harm to consumers, and also to competitive markets. This potential has escalated not only because of the increase in the quantum of

---

<sup>1</sup> Commerce Commission; Input methodologies review Draft Decision Related party transactions - Draft Decision and determinations guidance; 30 August 2017

<sup>2</sup> First Gas; Related party transactions: Draft Decision and determinations guidance; 27 September 2017' pg 5

transactions being done through related parties, but also the way the market is changing and the blurring of the line between what is, or is not, part of the regulated service, or a related party. As has been identified by the Commission, it is also difficult to show demonstrable harm because the information disclosures are not sufficiently adequate to be able to ascertain that. We note again, the letter from the Electricity Authority to the Commerce Commission, dated 1 June 2016, which stated:

*“In particular, the Authority is interested in the potential for the cost allocation arrangements to provide distributors with an advantage relative to other parties that reduces competition in ways that do not deliver long-term benefits to consumers.”*

And further, the letter to ERANZ from the Electricity Authority, dated 15 March 2017<sup>3</sup>:

*“Some distributors have been involved in competitive activities on their own network for quite some time, which is allowed by the Electricity Industry Act. Part 3 of the Act sets thresholds for distributors being involved in generation and retailing activities. However, evolving technology is giving rise to new opportunities for distributors to compete on their network-for example, in the form of peer-to-peer retailing-or to 'eat their network' by investing in non-traditional assets such as batteries and associated demand management capabilities.*

*Batteries and demand management capabilities are inherently contestable activities that could be provided by competitors as a service to distributors.*

*As distributors are in the privileged position of providing monopoly network services we have informed distributors that they need to take great care to avoid using their monopoly position to favour any of their own businesses that compete, or may compete, against other businesses.*

*We have also informed distributors that if they are involved in competing businesses then it would be desirable they develop - with their customers and competitors - a neutral access policy and information disclosure processes that provides those parties with confidence they are not discriminating in favour of their own businesses. In our view this needs to go further than simply ensuring equal access to, and sharing of, network data. Competitors will need some way of objectively verifying that the distributor's own business has not received any favourable treatment in regard to connecting to and using the network. Similarly, competitors will need some way of objectively verifying that the distributor has selected the least cost supplier of alternatives to traditional network assets.”*

## General support for Draft Decision

We observe the broad support for the Draft Decision in the submissions, in particular reliance upon a principles-based valuation approach and alignment with accounting/auditing standard definitions.<sup>4</sup>

A number of the comments and concerns raised in the submissions reflect an ongoing lack of clarity over the nature of a related party transaction as currently defined, the concept of the reporting entity and the relevance of cost allocations. As noted in our submission, ERANZ considers the root of much of this confusion is the ethereal nature of the current definition of the regulated service.

---

<sup>3</sup> Attached to the ERANZ submission to the Commerce Commission Issues Paper, dated 17 May 2017.

<sup>4</sup> Aurora; Submission; Related party transactions: Draft Decision and determinations guidance; 27 September 2017; pg 1  
ENA; Input Methodologies Review Draft Decision on related party transactions - Submission to the Commerce Commission; 27 September 2017; paras 3 & 14  
Powerco; Input methodologies review Draft Decision - related party transactions; 27 September 2017; pg 2

We comment further below on the following areas where we or others have raised particular issues:

- Definition of related party
  - Limb (b)
  - Cost-based valuation
- Information disclosure requirements
  - Procurement policies
  - Maps of anticipated network expenditure and network constraints
  - The independent assessor report
  - *de-minimis* for disclosure
- Transition

## Definition of related party

The proposed definition of ‘related party’ (and ‘related party transaction’) has generated a number of comments. ERANZ believes that this reflects a fundamental problem arising from the lack of a clear definition of the regulated service and, beyond that, shared services and other input costs. Accordingly, the appropriate treatment of various costs is likely to continue to be varied across regulated suppliers unless further clarity is provided.

While ERANZ supports the need for regulated suppliers to have flexibility in how they structure their businesses in order to maximise the efficient outcome for consumers of the regulated service, it is not clear that the efficiency gains are consistently passed onto consumers. For example, we note the following two EDBs, each with an engineering services function providing service to the regulated supplier and to third party customers:

- Unison has a separate legal entity which it consolidates for regulatory reporting purposes with the elimination of intra company profits (i.e. the service is reported at cost);<sup>5</sup> while
- Westpower has an internal division that it treats as a related party and for regulatory purposes reports its costs plus a 17.2% margin.<sup>6</sup>

These examples show that under the existing rules there are materially different approaches being taken, not all of which are likely to yield the most efficient price to consumers of the regulated service.

Marlborough Lines says of the related party definition:

*“This is a confusing situation and appears to come down to subjective assessments about whether a part or division of the entity operates the electricity lines service or supplies the regulated service.”<sup>7</sup>*

---

<sup>5</sup> Unison; Valuation of Related Party Transactions; 27 September 2017; pg 8

<sup>6</sup> Westpower; Submission to the Input Methodologies Review Draft Decision on Related Party Transactions; 26 September 2017; pg 2

<sup>7</sup> Marlborough Lines; Submission to the Commerce Commission on related party transactions Draft Decision and determinations guidance – 30 August 2017; 27 September 2017; para 17

## Limb (b)

A number of submitters are concerned about the inclusion of limb (b) in the definition of related party or, at least, the proposal to add the words “branch or division” to limb (b).<sup>8</sup> It seems that the Commission’s proposed change to the wording of limb (b) has drawn the attention of many parties to the concept that a related party could be a part of the legal entity that also provides the regulated service.

NZ IAS 24 refers to a related party as “a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the ‘reporting entity’)”.<sup>9</sup> As shown in diagram 1 of ERANZ’s submission to the Commission’s Draft Decision (reproduced in modified form below), it is possible that the ‘reporting entity’ in the case of the provision of the regulated service is only a part (or parts) of one (or more) legal entity(/ies). In other words, the regulated service reporting entity does not necessarily fall neatly into a ‘legal entity’ construct. For this reason, the NZ IAS 24 definition of related party on its own is not sufficient to apply to reporting in relation to the regulated service. This is why limb (b) is necessary.

The additional words proposed by the Commission provide further clarification but do not alter the intent or effect of limb (b). Accordingly, limb (b) has (and always has had) an important role in the definition of ‘related party’. Limb (b) is necessary to capture situations where, within the entity that provides the regulated service, another part (division or branch) provides services to the regulated service and proposes to charge more than cost. This is effectively shifting profits to the unregulated part of the business and increasing the cost to the consumers of the regulated service. It is not apparent how such an arrangement is efficient from the perspective of consumers of the regulated service.

The inclusion of limb (b) notwithstanding, the definition of related party remains opaque because there is no clear definition of what constitutes the provision of the regulated service, what might be a shared service (and therefore subject to cost allocation rules) and what is a service provided by a related party. In other words, the critical question posed in the first decision point in Figure B1 in the Draft Decision is not readily answered.<sup>10</sup>

ERANZ recommends that the Commission considers what additional definitions are necessary to provide the requisite clarity.

## Cost-based valuation methods

Many of the submissions on behalf of EDBs express concern over the apparent removal of an accounting consolidation (or cost) basis for reporting, what might otherwise be regarded as, related party transactions. ERANZ agrees in principle that costs for services provided to the regulated service should not exceed the cost of providing those services.

---

<sup>8</sup> Aurora; Submission; Related party transactions: Draft decision and determinations guidance; 27 September 2017; pg 3  
ENA; Input Methodologies Review Draft Decision on related party transactions - Submission to the Commerce Commission; 27 September 2017; para 17

Powerco; Input methodologies review Draft Decision - related party transactions; 27 September 2017; pg 2  
PwC; Submission to the Commerce Commission on Input methodologies review: Draft Decision on related party transactions - Made on behalf of 17 Electricity Distribution Businesses; 27 September 2017; para 7  
Unison; Valuation of Related Party Transactions; 27 September 2017; pg 1

Wellington Electricity; Response to input methodologies review: related party transactions Draft Decision; 27 September 2017; pg 1

<sup>9</sup> External Reporting Board; New Zealand Equivalent to International Accounting Standard 24 Related Party Disclosures (NZ IAS 24); Issued November 2009 and incorporates amendments up to and including 30 November 2012; para 9

<sup>10</sup> Commerce Commission; Input methodologies review Draft Decision Related party transactions - Draft Decision and determinations guidance; 30 August 2017; pg 74

We understand the value limitation provisions are intended to achieve this outcome. This is consistent with the view, expressed in our submission, that the relevant value is the lesser of actual cost incurred or the arm’s-length price/benchmark.<sup>11</sup> ENA similarly summarises the position:

*“[t]he ENA understands that ... the intention of the Draft Decision is for the transactions to be accounted for at no greater than arm’s length value (and at actual transaction value, where this is less).”<sup>12</sup>*

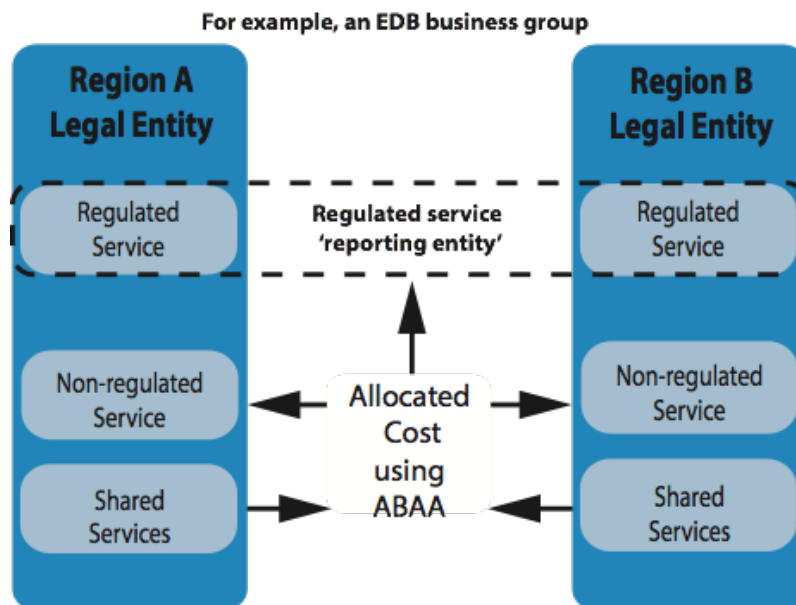
Vector draws a similar conclusion:

*“The new general valuation rule includes a limb which requires the actual cost of the transaction to be used if the RPT is found to be below arm’s length terms.”<sup>13</sup>*

We do not believe that services such as internal legal advice would need to be marked up to match market costs but, rather, would be reflected on a cost basis. However, as noted above, we acknowledge that the challenges of accurately defining the regulated service, shared services and services provided to the regulated service (i.e. other input costs) are likely to perpetuate the current ambiguity and misapplication of the rules.

Diagram 1 below shows the interplay between various elements of legal entity (or entities) that provide the regulated service and the parts (branches or divisions) thereof that support that service. The non-regulated service should charge for services to support the regulated service at cost (but the price should not exceed an arm’s-length price).

**Diagram 1: The reporting entity and the allocation of common costs**



<sup>11</sup> ERANZ; Submission to the Commerce Commission on the Input Methodologies Review Draft Decision on Related Party Transactions; 27 SEPTEMBER 2017; pg 27

<sup>12</sup> ENA; Input Methodologies Review Draft Decision on related party transactions - Submission to the Commerce Commission; 27 September 2017; para 4

<sup>13</sup> Vector; Vector submission on the Review Related Party Transactions Review Draft Decision; 27 September 2017; para 13

## Information disclosure requirements

The major concerns expressed in relation to the proposed information disclosure regime relate to the impact on the regulated business and the cost that consumers will ultimately bear.

Additional disclosures are warranted where the existing level of transparency is unsatisfactory and in light of additional latitude afforded regulated suppliers when establishing arm's-length values. However, ERANZ is aware of the need to ensure that the cost of additional disclosure does not outweigh the benefit.

Key areas of concern identified in submissions are the need for publication of procurement policies, the requirement for maps of anticipated network expenditure, the requirements for independent assessor's reports and proposals for a *de-minimis* level for disclosure of related party transactions. We comment on each of those areas below:

### *Procurement policies*

We note that some submitters are concerned that publication of their procurement policies may disclose information beyond that applicable to related party transactions.<sup>14</sup> The Commission has contemplated the potential for commercially sensitive information to be included in procurement policies and has therefore provided that only summaries need be made publicly available.<sup>15</sup> It would seem practical for regulated suppliers to craft the summaries in such a way as to avoid matters that do not impact on related party transactions and do not include commercially sensitive information. The Commission, in possession of the full procurement policy would need to ensure that the summaries were sufficient in relation to related party transactions.

### *Maps of anticipated network expenditure and network constraints*

ERANZ fully supports the requirement for the production of maps of anticipated network expenditure and network constraints and believes that requirement should extend to all regulated suppliers.

ERANZ believes that the provision of maps by regulated suppliers will provide benefits to competition and innovation. This will flow onto long term gains to consumers of the regulated service. There is some support for this in the submissions from EDBs and support for the view ERANZ expressed in its submission that the requirement should apply to all EDBs.<sup>16</sup>

However, in some cases that support is caveated by the view that the driver for this requirement does not directly arise from related party issues/provision of the regulated service and therefore should be deferred for consideration at another time.<sup>17</sup> ERANZ considers that these maps are very much connected to the activities of some related party activities and that reviewing information disclosure requirements is clearly within the scope of this review. The improved information disclosure by way of anticipated network

---

<sup>14</sup> Vector; Vector submission on the Review Related Party Transactions Review Draft Decision; 27 September 2017; para 32

<sup>15</sup> Commerce Commission; Input methodologies review Draft Decision Related party transactions - Draft Decision and determinations guidance; 30 August 2017; para 5.11

<sup>16</sup> ERANZ; Submission to the Commerce Commission on the Input Methodologies Review Draft Decision on Related Party Transactions; 27 September 2017; pg 26

Orion; Submission on input methodologies review Draft Decision - related party transactions; 27 September 2017; para 20  
Unison; Valuation of Related Party Transactions; 27 September 2017; pg 5

<sup>17</sup> Unison; Valuation of Related Party Transactions; 27 September 2017; pg 5

Vector; Vector submission on the Review Related Party Transactions Review Draft Decision; 27 September 2017; para 20

Wellington Electricity; Response to input methodologies review: related party transactions Draft Decision; 27 September 2017; pg 2

expenditure and network constraints would assist consumers, the Commerce Commission, EDB Directors, and other interested parties, to ascertain what expenditure may relate to a related party or other business, and thus whether the consumers are receiving the anticipated benefit and efficiency gains.

### *Independent assessor's report*

The independent assessor's report is one area where several submitters have suggested the requirement may be too onerous. ENA, for example, say:

*"the requirement for an expert report requirement [should] be removed because the requirements for it are too broad ..." and that "where an auditor is unable to form a view, the Commission is able to seek further information"*<sup>18</sup>

We note, however, that some other regulated suppliers have commented on the potential difficulties of establishing arm's-length or benchmark pricing and that they see the benefit of an independent assessor's report in those circumstances.<sup>19</sup> Aurora, for example, points to:

*"the difficulty and complexity involved in determining how to demonstrate that RPTs are at arm's-length."*<sup>20</sup>

In addition, PwC (in their auditor's submission) have commented that:

*"... depending on the quality and nature of support provided by the EDB there will be instances, especially in a non-market environment, where we will be unable to opine as there may not be sufficient independent evidence available to support the arm's length assumption.*

*We also draw your attention to paragraph A42 of ISA (NZ) 550 which highlights practical difficulties that auditors face when required to opine on whether the related party transaction terms were on an arm's-length basis. This is a real concern as the usual approach adopted by auditors is to remove the phrase "on an arm's length basis" as the work required to be done to give this opinion could be extensive and could still result in there being insufficient appropriate evidence to support the statement."*<sup>21</sup>

ERANZ believes that the independent assessor's report can play an important evidential role upon which auditors can rely when reaching their opinion on the arm's-length nature of transactions.

### *de-minimis level for disclosure*

There have also been calls in the submissions for a *de-minimis* level to apply to disclosures.<sup>22</sup> ERANZ does not support the use of *de-minimis* thresholds for disclosure in relation to related party transactions. While ERANZ is sympathetic to the impact of compliance costs on the many smaller regulated suppliers (especially

---

<sup>18</sup> ENA; Input Methodologies Review Draft Decision on related party transactions - Submission to the Commerce Commission; 27 September 2017; para 27

<sup>19</sup> Unison; Valuation of Related Party Transactions; 27 September 2017; pg 8

<sup>20</sup> Aurora; Submission; Related party transactions: Draft Decision and determinations guidance; 27 September 2017; pg 5

<sup>21</sup> PwC - Auditors; Submission to the Commerce Commission on Input methodologies review: Related party transactions – Draft Decision; 27 September 2017; paras 19-20

<sup>22</sup> ENA; Input Methodologies Review Draft Decision on related party transactions - Submission to the Commerce Commission; 27 September 2017; para 15

Powerco; Input methodologies review Draft Decision - related party transactions; 27 September 2017; pg 3

Vector; Vector submission on the Review Related Party Transactions Review Draft Decision; 27 September 2017; para 8



regionally-based EDBs), it is concerned that, where regulated suppliers are of considerably greater size, a large value of transactions could be excluded from disclosure under *de-minimis* thresholds.

## Transition

Submissions on behalf of EDBs have sought a deferral in transitioning from the current related party disclosure requirements to the new requirements due to the complexity of the additional requirements and the impact on regulated suppliers needing to review their internal processes and undertake market testing, etc.<sup>23</sup> This would see the new disclosure requirements commencing in 2019.

ERANZ believe that early reporting under the new disclosure requirements is essential in order to have robust and relevant information available for the Commission to use when addressing the next EDB price review. This is only achieved if the Commission's proposed commencement date in 2018 is achieved.

Thank you for the consideration of this submission. We are happy to discuss any parts of this submission in more detail if required. If you have any queries, please contact Jenny Cameron at [jenny.cameron@eranz.org.nz](mailto:jenny.cameron@eranz.org.nz).

Yours sincerely



Jenny Cameron  
**Chief Executive**  
**Electricity Retailers' Association of New Zealand**

---

<sup>23</sup> Aurora; Submission; Related party transactions: Draft Decision and determinations guidance; 27 September 2017; pg 5  
ENA; Input Methodologies Review Draft Decision on related party transactions - Submission to the Commerce Commission; 27 September 2017; para 28  
Orion; Submission on input methodologies review Draft Decision - related party transactions; 27 September 2017; para 20