Aurora
ENERGY LIMITED

Submission

Input Methodologies Review: Related party transactions – Invitation to contribute to problem definition

17 May 2017

DELTA
THINK.INFRASTRUCTURE

PREPARED FOR AURORA ENERGY LTD
BY DELTA UTILITY SERVICES LTD

Telarc SAI registered
ISO 9001

TABLE OF CONTENTS

1 Introduction 1

2 Aurora's key messages 1

3 The IMs review process 2

4 Is the concern about over-payment or transparency and efficiency incentives? 3

5 The problem definition lacks evidence of an over-payment problem 3

6 Problem definition should consider impediments to efficient use of RPTs 4

7 Replicating outcomes in competitive markets 6

8 Concluding remarks and recommendations 7

1 Introduction

Aurora welcomes this opportunity to submit in relation to the Commerce Commission's *Input methodologies review: Related party transactions – Invitation to contribute to problem definition, 12 April 2017* (the "RPT Paper"). Aurora supports the submissions of the ENA and PwC on this matter.

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

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

Alec Findlater
GM Network Commercial
Delta Utility Services
alec.findlater@thinkdelta.co.nz
(027) 222 2169

2 Aurora's key messages

The Commission has raised concerns about potential over-payments by regulated suppliers in RPTs. The RPT Paper assessment of the current RPT rules (and Information Disclosure requirements) suggests though, that if there is a problem, it is with transparency of current practices, with over-payment unproven.

Aurora appreciates that the Commission is currently developing its problem definition, but 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.

The potential solutions to over-payment (solution: tightening of the RPT rules) and transparency (solution: re-evaluation of Information Disclosure requirements) are quite different.

The RPT Paper appears to be one-sided in its problem definition. Consideration is given to whether the RPT rules could result in over-payment, but not to their potential to impede efficient use of related parties/RPTs, and/or under-payment in RPTs. We are disappointed that the potential for the existing RPT rules to be too restrictive has not been addressed. It is an issue we and other stakeholders have raised in prior submissions. Aurora raised the matter initially in response to the first of the Commission's IMs review consultations.

At the least, we would have expected details of why the Commission does not consider that the RPT rules could inhibit potentially efficient arrangements. The feedback from Deloitte and PwC auditors, cited in the RPT Paper, highlight that the rules are complex and that some regulated suppliers have restructured to make compliance easier. This is prima facie evidence, at least, that the RPT rules are acting as a barrier to efficient use of related parties/RPTs. The Commission should consider the risk that tightening the RPT rules could create or exacerbate barriers to efficient use of related parties/RPTs.

We reiterate our recommendations that:

- "*the Commission should review whether the practicability and usability of the RPT rules could be improved*"; and
- "*To this end, we agree with ENA that the RPT rules should be changed to: (i) remove the link between cost allocation and RPT rules created by the reference to "directly attributable costs,*

(ii) the directors' certification option should not be restricted to circumstances where no other option is available; and (iii) the IM and Information Disclosure Determination RPT rules should be aligned"[1].

We are also open to the principles-based approach that the Deloitte auditors have suggested the Commission consider.

3 The IMs review process

While some of our comments about the handling of the emerging technology topic have been negative, overall, we consider the Commission has run the IMs review process well. If the Commission seeks feedback post-IMs review our response will largely be positive.

The inclusion of a consultation step on problem definition prior to forming views on changes to the IMs is an important part of any good policy development process. We appreciate that the Commission is continuing in this vein with the release of a problem definition development paper on RPT, prior to making and consulting on draft decisions.

The Commission has also shown an ability to act nimbly and include additional consultation steps (and workshops) on matters that have proven to be contentious; notably, with gentailers[2] showing an interest in WACC issues and, in particular, emerging technology issues and their (potential) implications for cost allocation and RPTs etc.

We recognise that emerging technology has been somewhat of a touchstone issue for gentailers. They have shown much more interest in emerging technology than any other Part 4 matter. The gentailer submissions, particularly around cost allocation, show that they have found it challenging to engage in Part 4 processes, and struggled to get up to speed with, or fully understand, the IMs. The subject matter is technical and complex.

There has been a substantial gap between the level of attention emerging technology issues have been given, and evidence of actual (not just hypothetical) problems. Gentailer submissions have been high on rhetoric, but lack evidence or substantiation. This is a point we have made throughout the IMs review, providing gentailers with ample opportunity to respond with actual evidence[3]:

> "*Despite [emerging technology] being the one topic each of the incumbent gentailers, and their new representative body, ERANZ, submitted on, our observation remains unchanged. Each of the incumbents expressed concern about facing competition from EDBs, and the prospect (seemingly treated as a given) of cross-subsidies, but failed to provide any explanation or adequate evidence of problems with the current cost allocation and related party transaction (RTP) rules.* "

Gentailers still have ample opportunity to provide actual evidence of any problems with the RPT rules, at both this stage of the review process and in response to the RPT draft decision, if the concerns they have raised are soundly based.

[1] Aurora Energy (2016). *Cross-submission Input Methodologies Review: Draft Decision and Determination Papers*. 18 August 2016. section 4.

[2] Including their representative body, ERANZ.

[3] Aurora Energy (2016), *Cross-submission Input Methodologies Review: Draft Decision and Determination Papers*. 18 August 2016. page 2.

As the Commission progresses its consideration of whether there are problems with RPTs that warrants amendment to the IMs, and/or the Information Disclosure requirements, it should heed the High Court position that "*Where a proposition is simply asserted …, we give it little or no weight*"[4].

4 Is the concern about over-payment or transparency and efficiency incentives?

We are mindful that the Commission is using the RPT paper as an opportunity for stakeholders to contribute to the identification of whether there are problems with the existing RPT rules, and that the Commission will develop the problem definition as part of its Draft Decision.

As the Commission develops its problem definition more fully, in preparation for its draft decision, we would like to see greater clarity about whether the concerns are with over-payment in RPTs or transparency of RPT arrangements. The RPT Paper problem definition seems pitched towards the former, but the analysis of current RPT arrangements suggests the issue may be that the Commission doesn't feel it has surety or comfort from Information Disclosure that overpayment is not occurring.

The potential solutions to over-payment (solution: tightening of the RPT rules) and transparency (solution: re-evaluating Information Disclosure requirements) are quite different.

The RPT Paper also states that the Commission is "*… concerned that a supplier of a regulated service may be incentivised to use a related party for an input to the related service even though it may not be the most efficient provider of the input*"[5].

If this is valid, it is a problem with the Part 4 regime not providing regulated suppliers with strong enough incentives to innovate and improve efficiency, not a problem with the RPT rules.

The solution could be to rebalance the sharing of efficiency gains; e.g., allowing regulated suppliers to hold onto efficiency gains for longer before sharing them with consumers. Tightening the RPT rules would mask the symptom of the problem, rather than solving the problem itself.

5 The problem definition lacks evidence of an over-payment problem

Care is needed to ensure that decisions are sufficiently evidence-based. We raised this concern previously in the context of cost allocation: - "*Aurora is concerned that the Commission's Updated Draft Decision, and reliance on ERANZ and electricity retailer submissions for support, lacks an evidential basis – a potential repeat of the mistakes made with the original WACC percentile decision*"[6].

What strike us is that, despite over twenty years of Information Disclosure, and the Commerce Commission examining the practices of a sample of regulated suppliers, the RPT paper provides no indication or evidence of regulated suppliers making excessive payments for RPTs. The issue of RPTs is not a new issue that has arisen due to emerging technology.

---

[4] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC, 11 December 2013, paragraph [1745].

[5] Commerce Commission (2017). *Input methodologies review, Related party transactions – Invitation to contribute to problem definition*. 12 April 2017. paragraph 2.7.

[6] Aurora Energy (2016). *Submission, Input Methodologies Review: Updated Draft Decision on Cost Allocation*. 13 October 2016. page 1.

The RPT Paper notes that"*[o]ne example of how the terms and conditions could advantage the related party to the detriment of the consumer of the regulated service, is where the price for an asset or service charged to the regulated supplier is higher than would be paid in an arm's-length transaction (ie, between independent parties)*"[7]. We agree. What is needed is evidence of transactions that are set higher than would be paid in an arm's length transaction.

The Commission needs to attempt to identify evidence of:

- scope or ability of "*suppliers of the regulated service … to use an unregulated related party to increase their combined profits by overcharging for inputs to the regulated service that are supplied by the related party*"[8];
- specific examples or evidence of related unregulated service providers supplying inputs at increased prices, the scale and materiality of such activity, and the extent to which it could be undermining the statutory objective to limit excessive profits[9]; and
- specific examples or evidence of suppliers of a regulated service using "*a related party for an input to the related service even though it may not be the most efficient provider of the input*"[10].

6 Problem definition should consider impediments to efficient use of RPTs

The RPT Paper appears to be one-sided and somewhat imbalanced.

While the RPT Paper raises the possibility RPTs could be set at levels that inflate costs/mask the profitability of the regulated business, it does not address whether the RPT rules could:

- result in RPTs being set at prices that are too low; and/or
- act as a barrier to regulated businesses using related parties, rather than third parties, even where the former is more efficient.

Tightening the RPT rules could cause or exacerbate these potential problems. Such an outcome would be inconsistent with "reasonable investor expectations" (or the NPV = 0 principle) that suppliers should be able to recover prudent and efficient costs[11]. In our view this includes recovery of prudent and efficient costs from RPTs. The RPT rules could also inhibit regulated suppliers' ability to innovate and/or improve efficiency, to the detriment (higher prices than otherwise) of consumers.

What is clear from the Commission's "*[l]earnings from our discussions with sector auditors*" is that the potential issues with the RPT rules could result in under or over-charging. The Commission has only considered the latter. Deloitte noted "*that the related party transactions rules are complex and it*

[7] Commerce Commission (2017). *Input methodologies review, Related party transactions – Invitation to contribute to problem definition*. 12 April 2017. paragraph 2.32.

[8] Commerce Commission (2017). *Input methodologies review, Related party transactions – Invitation to contribute to problem definition*. 12 April 2017. paragraph 2.5.

[9] Commerce Commission (2017). *Input methodologies review, Related party transactions – Invitation to contribute to problem definition*. 12 April 2017. paragraph 2.6.

[10] Commerce Commission (2017). *Input methodologies review, Related party transactions – Invitation to contribute to problem definition*. 12 April 2017.paragraph 2.7.

[11] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC, 11 December 2013, paragraph [605].

has had to resolve issues with an audit client on the varying interpretations of the rules, particularly the classification and measurement of related party transactions"[12].

Similarly, PwC's commented that it "*has seen examples of suppliers of regulated services restructuring to make it easier to comply with our rules. It has also seen suppliers using the directors' certification valuation option for the disclosure of related party transactions due to difficulty in complying with the other options for some businesses*"[13]. This clearly highlights there are problems with the existing RPT rules which impede their efficient use.

The RPT Paper makes no mention of these issues or, if the Commission has considered them, why it does not consider that they need to be included in the review of the RPT rules. The closest the Commission gets is the statement that "*[w]e 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*"[14]. What would be more reassuring is if the Commission tested, as part of its problem definition, if anything about the RPT rules might prevent regulated suppliers operating in this way.

Aurora and others have raised the issue that the RPT rules may be too restrictive as a matter the Commission should consider as part of its review of the RPT rules. At the very first consultation step in the Commission's IMs review we identified this issue as a priority area[15]. We do not feel the Commission has engaged with the concerns we raised[16]:

> "*The concern we have with the current related party arrangements is that they act too rigidly to avoid over-payment by EDBs for related party transactions, and this can give rise to the opposite problem.*
>
> *This is highlighted by the difference between valuation at group consolidated cost (IMs 2.2.11 (5)(g)), and market value (IMs 2.2.11 (5)(f)).*
>
> *By way of example, take a comparison of nine distribution projects, comprising a mix of asset relocations, undergrounding, feeder refurbishment, and bulk pole replacements. The comparison highlights that valuation at group consolidated cost resulted in a valuation that was approximately 21% lower than market valuation. Whilst the Commission allows valuations to be "updated" following market valuation, the implication for EDBs is that they must bear this reduced value for many years, owing to the fact that market valuations take time to complete, and the resource pool for undertaking them is quite small. The knock-on effect is that capital allowances at the reset are likely to be understated, since the allowance is pegged against historical out-turn.*"

We continued to raise our concerns in response to the Commission's draft decisions:[17]

> "*Irrespective of the motivations for procuring services from related parties, a fundamental objective of the related party valuations provisions, whether they reside in the IMs or Information Disclosure, is the recovery of efficient expenditure at prices that would be observed in an arms-length transaction, in a competitive market. In Aurora's view, the Commission's focus should lie here, rather than getting tied up in the specific motivations for the existence of related party transactions.*"

The only recognition of our submissions on this matter is the observation, with no response, that "*[s]ome entities noted that some other options were unable to be applied to their situation. In*

[12] Commerce Commission (2017). *Input methodologies review, Related party transactions – Invitation to contribute to problem definition*. 12 April 2017. paragraph 3.23.

[13] Commerce Commission (2017). *Input methodologies review, Related party transactions – Invitation to contribute to problem definition*. 12 April 2017. paragraph 3.34.

[14] Commerce Commission (2017). *Input methodologies review, Related party transactions – Invitation to contribute to problem definition*. 12 April 2017. paragraph 2.28.

[15] Aurora Energy (2015). *Submission In response to the Commerce Commission's Open letter on our proposed scope, timing and focus for the review of input methodologies.* 31 March 2015. section 5.

[16] Aurora Energy (2015). *Submission In response to the Commerce Commission's Open letter on our proposed scope, timing and focus for the review of input methodologies.* 31 March 2015. subsection 5.1.

[17] Aurora Energy (2016). *Submission Input Methodologies Review: Draft Decision and Determination Papers.* 4 August 2016. section 13.

Aurora's submission on the IM review draft decision, it noted that the related party rules should be reviewed to ensure they can be applied in the circumstances where they are appropriate"[18].

Similarly, the Commission noted, without response, that "*Alpine Energy's submission on the IM review outlined issues with the application and usability of the related party transactions rules*"[19].

The Commission engaged slightly more with the ENA concern that the RPT rules should "*provide for the fair recovery of costs, at arm's-length prices*"[20]. The Commission ignored, though, the ENA qualification "*at arm's length prices*" which would dictate that fair recovery would be limited to "*prudent and efficient*" costs. The Commission misrepresented the ENA argument by suggesting it could promote recovery of costs "*where a related party may be grossly inefficient*"[21]. Even without the qualification "*at arm's length prices*" we question whether "*fair*" can be interpreted as implying recovery of "*grossly inefficient*" costs.

Even if the Commission does not consider that the RPT rules presently create an impediment to using related parties/RPTs, any tightening up of the RPT rules to reduce the possibility of over-inflated prices for RPTs risks creating impediments to the efficient use of RPTs. The Commission should be mindful of this risk when it considers making changes to the RPT rules.

In our view, the Commission must be mindful of the potential for consumers to be adversely impacted, in the long run, if an EDB's allowable revenue is affected by under-recognition of its prudent and efficient capital and maintenance input costs as a consequence of an RPT valuation framework that systematically adjusts input costs to below an arm's length equivalent. Such an impact on consumers was discussed in the Commission's decision paper on form of control.[22]

7 Replicating outcomes in competitive markets

It could be useful to compare the RPT rules against related party arrangements in competitive markets to help determine whether the current RPT rules should be tightened or loosened.

This would be consistent with the aim of the statutory objective, to replicate the outcomes of competitive markets. Aurora has previously commented that one of the fundamental outcomes for the rules for valuations RPTs is that "*[t]he resultant valuation must approximate an arms-length transaction in a workably competitive market*"[23].

The Commission would not have to go far to determine competitive market benchmarks.

An obvious comparator would be to consider the types of arrangements gentailers have in place between their generation and retail businesses. We would expect, based on gentailer engagement in the emerging technology topic, that they would welcome the opportunity to contrast the arrangements they have in place to ensure arms-length transactions, and transparency of the

[18] Commerce Commission (2017). *Input methodologies review, Related party transactions – Invitation to contribute to problem definition*. 12 April 2017.paragraph 3.44.

[19] Commerce Commission (2017). *Input methodologies review, Related party transactions – Invitation to contribute to problem definition*. 12 April 2017. paragraph 3.42.2.4.

[20] ENA, Input Methodologies review - Topic paper 7, related party transactions, 4 August 2016, page 4.

[21] Commerce Commission (2017). *Input methodologies review, Related party transactions – Invitation to contribute to problem definition*. 12 April 2017. paragraph 2.61.

[22] Commerce Commission (2016). *Input methodologies review decisions, Topic paper 1: form of control and RAB indexation for EDBs, GPBs and Transpower.* 20 December 2016, paragraphs 81 & 82.

[23] Aurora Energy (2016). *Submission Input Methodologies Review: Draft Decision and Determination Papers.* 4 August 2016. section 13.

performance and profitability of their two main business arms for shareholders, with the practices of monopoly regulated suppliers.

8 Concluding remarks and recommendations

Aurora does not support proposals to tighten the RPT rules.

The Commission's assessment of the current RPT rules, in the RPT Paper, appears to indicate that, if there is a problem, the problem is with transparency of current RPT arrangements. The solution to this would be to look at options for enhancing Information Disclosure requirements, rather than tightening the RPT rules/excluding particular RPT options such as director certification.

The Commission has stated that "*[o]ur concern is that suppliers of regulated services have the ability to use an unregulated related party to increase overall profits by overcharging for inputs supplied by the related party. Such inputs into the regulated service may be overpriced, as the supplier of the regulated service and the unregulated related party have a common profit incentive*"[24]. Aurora is concerned that suppliers of regulated services could find themselves in positions where they either have to use a less efficient third party or artificially understate their regulated business costs/inflate their profits by discounting inputs supplied by the related party.

Justification for tightening the RPT rules should include actual evidence of problems with over-payment or charging to related parties, not just hypothesis or intuitive judgment. No such evidence has been forthcoming in the IMs review so far, despite issues around cost allocation and RPTs being a touchstone topic for gentailers from the outset of the IMs review.

We reiterate our recommendations that:

- "*the Commission ... review whether the practicability and usability of the RPT rules could be improved*"; and
- "*To this end, we agree with ENA that the RPT rules should be changed to: (i) remove the link between cost allocation and RPT rules created by the reference to "directly attributable costs, (ii) the directors' certification option should not be restricted to circumstances where no other option is available; and (iii) the IM and Information Disclosure Determination RPT rules should be aligned*"[25].

We are open to Deloitte's recommendation that the Commission consider "*a more principles-based approach to our rules (eg, based on a statement of purpose), with questions which support the reasonableness of the value of the transaction, and that such an approach should be able to be applied cross sector*"[26].

[24] Commerce Commission (2017). *Input methodologies review, Related party transactions – Invitation to contribute to problem definition*. 12 April 2017. paragraph 2.53.

[25] Aurora Energy (2016). *Cross-submission Input Methodologies Review: Draft Decision and Determination Papers*. 18 August 2016. section 4.

[26] Commerce Commission (2017). *Input methodologies review, Related party transactions – Invitation to contribute to problem definition*. 12 April 2017. paragraph 3.26.