



20 September 2017

Keston Ruxton

Manager, EAD Regulation Development

Regulation Branch

By email: regulation.branch@comcom.govt.nz

Dear Keston

Submission on input methodologies review draft decision- related party transactions

Orion New Zealand Limited (Orion) welcomes the opportunity to comment on the Commerce Commission's (the Commission) paper "**Input methodologies review draft decision related party transactions**", 30 August 2017.

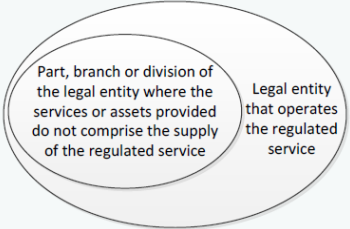
1. Overall our interpretation is that the draft decision equates to a greater level of information disclosure evidencing transactions with related parties are arm's length (i.e. policies, processes, and examples of transactions) as well as requiring less "qualified" directors' certification.
2. The principles-based approach has merit however what is missing is appropriate weighting of other important context. In the long term, principles of safety, resilience and contractor capability should not be compromised at the expense of disproportionate low level transactional oversight. It is important that contractors have levels of market certainty to maintain competencies, innovate and stay in the market. Our focus should be on evidence that supports long term gains for consumers rather than short term gains.
3. Regulation of related parties occurs through both the input methodologies (IMs) and information disclosure (ID) requirements. The IMs cover the valuation of assets (capex) acquired from a related party. The IDs cover the valuation of services (all opex) acquired from a related party and the valuation of sales supplied to a related party. Consequently the draft decision proposes changes to both IMs and ID. The proposal is for the transactions to be valued at actual transaction value (valuation limitation). Specifically where the transaction is less than arm's length prices are valued at no additional margin above the purchase price when costing it into the cost of the regulated service.

Principles based approach

4. We support the move to a more principles-based approach. The removal of multiple valuation options provides simplicity and removes some of the difficulty with interpretation in the current arrangements. However the detailed requirements underpinning the principles based approach, set out in the general valuation rule, inevitably lead to specific and somewhat prescriptive disclosure requirements which may lead to inefficient compliance costs.
5. We support the role of auditors to test the application of the rule. We believe this is a cost effective and practical approach. We submit that auditors will need to consider factors other than pure cost when assessing whether transactions are appropriate and at arm's length. Our procurement policy currently requires business judgement/assessment with respect to contractor capability, quality, reliability, health and safety compliance and asset and/or network knowledge. This underpins our principle of a lowest **conforming** bid tender process i.e. cost is not the only factor in service procurement. A winning bid (even in a competitive tender) may not be the lowest cost in the short term but is the most efficient and effective solution in the long term. These factors need to be expressly contemplated in the assessment of transactions with related parties.
6. As a purpose driven business the capability and resilience of our contractors underpins our service performance. Any assessment of the related party transactions needs to give appropriate consideration to the need for resilience. The ability to exercise judgement in procurement decisions particularly when it comes to continuity and initial emergency services response should be preserved. Delivering resilience and an efficient service may necessitate sole supplier arrangements (e.g. for emergency spares management via services fee or initial emergency response services via a schedule of rates) potentially via a related party. Bulk storage of equipment and sole supply of initial emergency response services may make good service and economic sense. It is appropriate to acknowledge that there can be significant trade-offs in a relatively small and specialised contracting market. We would like these principles captured in any determination.
7. We support your proposal to incorporate the accounting and audit standards by reference into the IM and ID determinations. This should support consistency of approach across EDBs underpinned by New Zealand standards.

Scope of related party definition

8. We support the alignment of the related party definition with NZ IAS24. We do have a concern regarding the proposal to extend the related party definition¹ beyond the traditional relationships into business units. The examples provided create uncertainty. The definition of related party needs redrafting and improvements to clarify scope.
9. The Commission’s example (b) in Table 4.4 (provided below), understanding the related party definition, of its draft decision seems to capture internal functions who provide only regulated services. For example network operators within an operational division of an EDB who only provide the regulated service of system switching are captured by the example description. While they do reside in a division of the regulated business they solely supply the regulated service e.g. they **do** supply the regulated service, rather than, they **do not** supply the regulated service. The example in table 4.4 seems to go counter to the ‘tier’ and diagram description.

Tier ⁷⁴	Detail	Example/s	Diagram
<p>(b) any part, branch or division of the regulated business that does not supply the regulated service.</p>	<p>As we regulate the service and not the legal entity, any part of the entity that operates the regulated service, but which does not supply the regulated service, is considered a related party.</p>	<p>The entity that operates the electricity lines service also has a contracting division which provides a range of repairs and maintenance, vegetation management and minor capex builds to the regulated service is considered a related party for regulatory purposes.</p>	

10. We believe that the policy intent was not to capture the value of internal services. As a case in point, does the Commission envisage that an individual employee within a department of Orion who provides streetlight database administration on behalf of a third party and Orion become a related party? The third party provides revenue to Orion for database administration and development. The materiality of that revenue is insignificant. This situation should be handled by cost allocation rules.
11. The related party definition should be appropriately targeted at genuine related party situations and we submit some more clarity is provided in this regard.

¹ **related party** means- (a) **person** that is related to the **EDB**, where the **EDB** 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 **EDB** that does not **supply electricity distribution services**;

Transactional materiality

12. Along with the expanded scope of the definition of related parties, the paper also appears to capture every and each related party transaction². We suggest that the scope of transactions that are to be included should be narrower. It is not clear where cost allocation rules apply as opposed to related party rules. In particular we believe there should be carve out for low value transactions to avoid inefficiency of administration costs versus value of transaction. Each transaction is an extremely high bar especially in the context that:

- we do hundreds of jobs via our contractors each year.
- small transaction levels are common – the costs of proving arms-length for many will outweigh any benefits.

Assurance reports

13. We support the role of auditors to test the application of the rule however where an auditor's assurance report concludes that the EDB has complied with the requirements, and directors have certified the same, there should be no need for the 65% threshold test and requirement for an additional independent report. We agree that if the assurance report concludes that the EDB has not complied then the additional independent report is appropriate. If this approach is taken compliance costs will be reduced while meeting the policy intent. We provide suggested alternative wording in Appendix I.

Director certification

14. With reference to our comments on transactional materiality we submit that the changes in the level of transactional certification required by directors and the removal of current qualifications (such as "to the best of our knowledge and belief") is an unreasonable threshold. We recommend that the qualification "to the best of our knowledge and belief" should be retained in Schedule 18.

15. Directors rightly rely on auditor assurance via sample testing of requirements and management reporting to ensure that business policy is being complied with. Their role is governance rather than detailed review at transactional level.

² Related party transaction means the transfer of an asset or the provision of a good or service between a related party and the part, branch or division of the EDB that supplies the electricity distribution service;

Information disclosure

Procedures for referral of a consumer to a related party

16. It is unclear what evidence the auditor should seek to ensure that consumers are appropriately referred to potential service providers including related parties.
17. Our connections and extensions policy provides the commercial terms we apply for extensions to our network, for new connections in areas with existing supply, and for alterations to existing connections. In particular “The customer must pay for the design (to our standard specifications) and construction of all 11kV and low voltage extension work (including the installation of the distribution transformer). The customer is able to select from a number of contractors approved by us for this work. Customers are also responsible for their own electrical installation, including the provision and installation of the line or cable from the network connection point to their premises or plant.” We also state that “productive efficiency - construction costs are minimised where works are carried out by independent competing contractors and economies of scale are achieved as Orion provides the large common items such as transformers and switchgear.”
18. Once customers are referred to potential service providers we have no influence over which, if any, proposals or price they accept.
19. Assuming that such a policy, where applied in practice, satisfies the Commission’s intent with respect to referral procedures of a consumer to a related party, this requirement appears acceptable.

Map of anticipated network expenditure and network constraints

20. Clause 2.3.10 of the draft electricity distribution information disclosure amendments determination requires disclosure, with the AMP or AMP update, of a map of future network expenditure and network constraints where an EDB has related party transactions in any expenditure category “in its most recently completed disclosure year.” An example could be where an EDB uses a related party contractor for maintenance works but is now required to disclose maps about forthcoming capex projects which may not be delivered by the related party contractor. The intent of this disclosure requirement appears to be the provision of a map of various future constraints/projects in our AMP regardless of whether the constraint or project would be resolved by a related party or not. If this is the case, then this clause should apply to all EDBs rather than only those with past related party transactions. We then question the appropriateness of the map request within the related party provisions.

21. We acknowledge that the provision of such a map by all EDBs would be complementary to providing transparency for potential third party non network alternatives. However it would be more appropriate as part of AMP disclosure rather than part of AMP disclosure via related party requirements. Regardless we provide suggested alternative wording in Appendix II.

Timing

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

Cost of compliance

21. Given the broad proposed definition of related party and the highly transactional nature of what is proposed we suggest that EDBs compliance costs will increase. Our submission points seek to minimise these costs as far as reasonably practicable while meeting the Commission's intent.

Concluding remarks

Thank you for the opportunity to make this submission. We do not consider that any part of this submission is confidential. If you have any questions please contact Dayle Parris (Regulatory Manager), DDI 03 363 9874, email dayle.parris@oriongroup.co.nz.

Yours sincerely



Dayle Parris

Regulatory Manager

Appendix I - Proposed rewording of Section 2.8.3- draft information disclosure determination

2.8.3 An **EDB** must procure, and **publicly disclose** at the same time as the **EDB publicly discloses** the **audited disclosure information**, an additional independent report from an **independent appraiser** prepared in accordance with clause 2.8.4 where-

~~(1) the proportion of the **EDB's total operational expenditure** accounted for by **related party transactions** exceeds 65% of the total **operational expenditure** of the **EDB** in the **disclosure year**;~~

~~(2) the proportion of the **EDB's total capital expenditure** accounted for by **related party transactions** exceeds 65% of the total **capital expenditure** of the **EDB** in the **disclosure year**;~~

(1) ~~(3)~~ the **independent auditor** is not able to conclude that the valuation or disclosures of **related party transactions** in the **disclosure year** complies with clause 2.3.6 of this determination and clauses 2.2.11(1)(g) and 2.2.11(5) of the **IM determination**; or

(2) ~~(4)~~ subclause ~~(1)~~ or ~~(2)~~ applied for the preceding **disclosure year** **subclause (1) applied** and time constraints did not permit the preparation of an additional independent report for that preceding **disclosure year** before the **independent auditor** issued their opinion for that **disclosure year**.

Appendix II- Proposed rewording of Clause 2.3.10- draft information disclosure determination

Map of anticipated network expenditure and network constraints

2.3.10 Where an ~~EDB~~ has ~~related party transactions~~ in any ~~capital expenditure category~~ or any ~~operational expenditure category~~ in its most recently completed ~~disclosure year~~, ~~T~~he EDB must publicly disclose with the AMP or AMP update a map of its electricity distribution service territory, which includes-

- (1) future expenditure in those **operational expenditure categories**, and its likely timing, value and location, in the **AMP planning period**;
- (2) future **capital expenditure** projects in those **capital expenditure categories**, and the likely timing, value and location of the projects, where any future **capital expenditure** project is forecast to be one of the 10 largest **capital expenditure** projects in the **AMP planning period**;
- (3) possible future **network** constraints and their location, **if known in advance of the need**, where the responses to the constraints are likely to involve **operational expenditure** in the **AMP planning period**; and
- (4) possible future **network** constraints, **if known in advance of the need**, where the responses to the constraints are likely to involve **capital expenditure** that is likely to be one of the 10 largest future **capital expenditure** projects in the **AMP planning period**.

2.3.11 For the purposes of clause 2.3.10, the map must be consistent with the **AMP** information specified in-

- (1) clause 11.8.3 of Attachment A on **network** or equipment constraints;
- (2) clause 11.8.4 of Attachment A on the projected impact of demand management initiatives;
and
- (3) clause 11.10 of Attachment A on the network development programme.