17 May 2017

PO Box 10742, Wellington
Level 2, Harbour City Tower
29 Brandon Street
Wellington, New Zealand
contactenergy.co.nz

Keston Ruxton
Manager, Regulation Development
Regulation Branch

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

Dear Keston

Input Methodologies Review – Related party transactions

Introduction

Thank you for the invitation to contribute to the Commerce Commission's (**Commission**) problem definition for related party transactions. Throughout the Input Methodologies Review (**IM Review**) Contact has strongly advocated for regulatory settings which promote the long term interests of consumers. We therefore welcome the opportunity to comment on the provisions around related party transactions, particularly with regards to emerging technologies,[1] and how they have the potential to frustrate the achievement of Part 4, Commerce Act 1986 (**Part 4**), and impact on consumers.

We agree with the concerns of the Commission, that suppliers of regulated services have the ability 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. This results in the extraction of excessive profits for monopoly services, and poor outcomes for consumers of regulated, and unregulated, services alike.

Related parties and emerging technologies

Contact considers the related party transactions regime is an important tool in the context of the nascent emerging technology market. The use of emerging technology assets by electricity distribution businesses (**EDB**) to generate a mix of regulated and unregulated revenue, means the boundary between the regulated (traditional 'poles and wires') and competitive markets are becoming blurred. We therefore query whether potential amendments to the related party transactions regime alone is the most useful mechanism to address issues relating to EDBs' direct participation in competitive markets. We consider the utilisation of the related party transactions regime as unlikely to reduce regulatory complexity, cost, and address the fundamental efficacy issues of EBD involvement in competitive activities. The International Energy Agency (**IEA**) have recently said:[2]

[1] Emerging technology is taken to include (but not be limited to) solar photovoltaics, batteries, demand response, electric vehicles and associated infrastructure, and other new energy technologies which can be provided by a competitive market.
[2] https://www.iea.org/publications/freepublications/publication/EnergyPoliciesofIEACountriesNewZealand2017.pdf at pg 142.

> *There are emerging concerns with regulated distribution businesses being able to compete in unregulated parts of the sector. The most obvious is battery technologies, which enable a distributor to defer/avoid line investment but can also be used to sell electricity into the wholesale and ancillary services market. There is potential here to create an "unlevel" playing field and undermine competition, which in the case of New Zealand could have serious ramifications. In particular, rapid technology change and uptake problems in this regard could be exploited rapidly and it may be hard to "turn back the clock".*

While we commend the Commission for identifying issues associated with related party transactions, we would encourage the Commission to work with other regulatory bodies and to take a broader, system-wide, view to achieve the desired policy outcome, rather than focussing on potential amendments to the related party transaction regime. EDBs' ability to leverage their monopoly position as a provider of regulated services into emerging technology activities, in particular, means competing providers may be deterred from entry as they cannot compete on terms available to EDBs. In this respect, we also consider the Competition branch of the Commission has an important role to play in the IM Review.

Related parties and broader structural issues

As the overarching purpose of the related party regime is to ensure parties are transacting on an arm's-length basis, ring-fencing appears to be one of the most effective way of achieving this. Ring fencing, by definition, avoids information asymmetries between monopoly services and related/ third parties, ensuring arm's-length "market" based terms and conditions are negotiated. This would reduce ongoing compliance and regulatory costs, while at the same time minimising the complexity of the Information Disclosure requirements. We do acknowledge there would be some initial and ongoing transition costs, but we consider the long-term benefits of structural reform would significantly outweigh these costs. Many international jurisdictions have also recognised this, and have separated the competitive and monopoly elements of the supply chain.

That being said, ring-fencing is not the only model for addressing the leveraging of regulated service providers' monopoly positions. Contact has previously raised the distribution system operator (**DSO**) concept as an alternative.[3] This is being implemented in New York under the Reforming Energy Vision programme, and is also supported in New Zealand by the IEA:[4]

> *(The DSO) model could support more efficient and transparent transactions between multiple market participants, thereby increasing competition and innovation, reducing transaction costs… it maintains a more effective separation of contestable and natural monopoly functions, resulting in a more coherent set of commercial incentives for distributors consistent with the principles of sound governance and efficient delivery of their core functions. It is also likely to strengthen the effectiveness of the regulatory regime and simplify its ongoing application and development.*

Contact believes potential amendments to the related parties regime will not adequately address issues of complexity, compliance, transparency of disclosures, participant discrimination, market foreclosure, and cost-shifting issues. We consider the addition of further prescriptive regulations within the IM Review and Information Disclosure provisions as useful (vis a vis the status quo), but by no means a long-term solution to the structural issues facing the sector. We would

[3] http://comcom.govt.nz/dmsdocument/14524.
[4] Above n 2.

encourage the Commission, at this early stage of the related party transactions review, to broaden the ambit of its approach to address whether ring-fencing, or the DSO concept, more appropriately align with the policy intent of related party transactions regime. Contact submits either approach would:[5]

- Promote outcomes produced in competitive markets;
- Incentivise innovation and investment;
- Encourage services at a quality that reflects consumer demand;
- Distribute efficiency gains with consumers, particularly through more competitive network pricing;
- Limit EDBs' ability to extract excessive profits; and
- Reduce regulatory complexity by removing the requirement to monitor EDBs' usage of competitive assets in a non-distortionary way (rather than simply regulating 'poles and wires').

For the avoidance of doubt, Contact supports EDBs investing, competing, and obtaining the benefits of emerging technologies by contracting for network services from ring fenced affiliates or third parties. We do not consider EDBs should be precluded from participating in such services, but EDBs should provide these services on a level-playing field that will better promote the achievement of Part 4's objectives.

Proposed next steps

If under the current related party transaction regime the value at which an asset/ service is transferred is susceptible to manipulation this would be a concern. It could lead to perversities for the operation of regulated entities, and the competitive market. In the end, all consumers suffer.

Contact therefore encourages the Commission to ascertain whether refinements to the related party transaction regime would be more beneficial than structural change. Specifically, we suggest the Commission undertake a cost-benefit analysis to:

1. Assess how improvements to the visibility of transactions, prices, terms, and availability and transparency of network support service contracts would better meet the purpose of Part 4; and
2. Compare those findings with an assessment of the benefits of structural reform (ring-fencing or DSO concept) in meeting the purpose of Part 4.

We look forward to continuing to engage with the Commission on the IM Review.

Yours sincerely

Catherine Thompson
General Counsel

[5] Section 52A Commerce Act 1986.