
Submission to the Commerce Commission

on

Input methodologies review: Related
party transactions – invitation to
contribute to problem definition

Made on behalf of 16 Electricity Distribution Businesses

*PwC submission on
behalf of a group of 16
electricity distributors*

17 May 2017

Introduction

Overview

1. This paper forms our submission on the Commerce Commission's (Commission) Consultation Paper, "Input methodologies review, Related party transactions – Invitation to contribute to problem definition" released on 12 April 2017 (the Consultation Paper). This submission has been prepared by PricewaterhouseCoopers (PwC) on behalf of the following 16 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
 - OtagoNet Joint Venture
 - The Lines Company Limited
 - The Power Company Limited
 - Top Energy Limited
 - Waipa Networks Limited
 - Westpower Limited.
2. Together these businesses supply 22% of electricity consumers, maintain 37% of total distribution network length and service 61% of the total network supply area in New Zealand. They account for around 55% of related party operational expenditure and around 62% 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 Consultation Paper. 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

Policy intent and problem definition

5. The EDBs who support this submission broadly support the problem definition and policy intent set out in the Consultation Paper, which can be summarised as:
 - the key objective of the related party regime should be the proper identification of demonstrable arm's-length like terms and prices for related party transactions, and
 - complexity and inconsistency in the current regime means this objective is difficult to achieve, and may not be being achieved in all instances.
6. A significant source of complexity is the level of prescription used in the current regime. The EDBs believe a key objective of this review should be the design of a principles-based regime that is adaptive to the individual circumstances of suppliers, which avoids prescription and complexity, and which allows for the identification of arm's-length prices by suppliers, supported by evidence. Such a regime could be supported by published guidance, which could incorporate elements of the existing regime.

Issues identified by the Commission

7. The Consultation Paper goes into some detail about issues that could be better characterised as symptoms or consequences of the deficiencies in the current regime, rather than as problems in themselves. The EDBs consider this approach risks complicating the review and that many, if not all, of these 'sub-problems' could be resolved by replacing the current complex and inconsistent provisions with a principles-based regime. The new regime can then be checked against these 'sub-problems' to ascertain whether any still need to be addressed.
8. One issue that is unlikely to be able to be resolved as part of the review is the existence of imperfect local markets for contracting services, which are better described as markets lacking access to scale. The problem is inherent in the sector, and particularly for the EDBs named in this submission, many of whom operate within markets that experience issues of access to scale. These EDBs consider the objective of the review should be not to fix these markets, but to provide a principles-based regime that can be applied within those markets to best identify arm's-length prices.

Misuse of related party transactions

9. The EDBs who support this submission are concerned at the implication that related party transactions may be being deliberately used by some EDBs to increase profits by circumventing the regulatory regime. There is no evidence that this is the case. Rather, EDBs have been attempting to apply, in good faith, a regime that is not currently fit for purpose.
10. It is not appropriate to allege or infer bad behaviour against EDBs when there is a demonstrable problem with the design of the regime. Moreover, if the focus of the review becomes the prevention of perceived or potential bad behaviour, it risks losing sight of the proper objective of the review, which is to produce workable and effective provisions for the identification of arm's-length prices.

Input Methodologies and Information Disclosure Determinations

11. The issue was deferred for consideration later in the IM Review process because it involved problems in the Information Disclosure Determinations (IDDs) as well as the Input Methodologies (IMs). Having deferred the issue for this reason, it is important that the issues in both the IDDs and IMs are now resolved.

Policy intent and problem definition

Commission's policy intent and problem definition

12. The EDBs who support this submission broadly support the policy intent and problem definition set out in the Consultation Paper. That is, the policy intent is to ensure:
 - related party transactions are treated and expressed in a way that is akin to transactions made at arm's length values and terms; and
 - where a regulated supplier transacts with a related party, the value of the transaction should therefore be based on a demonstrated objective and independent measure, which may differ from the actual purchase price.
13. The problem is described as, broadly, that the current application of the related party provisions is not well aligned with the policy intent. More specifically:
 - aspects of the way the related party transactions rule has been designed and implemented raises a risk that the related party transactions policy intent will not be achieved (problem one); and
 - aspects of the way in which some regulated suppliers have applied the rules also raises the risk that the related party transactions policy intent is not being achieved in practice (problem two).

Discussion

There is nothing inherently wrong with related-party transactions

14. The EDBs who support this submission are pleased to see that, aside from signalling its concern about the potential for misuse of related party transactions, the Consultation Paper does not conclude that there is anything inherently wrong with EDBs using related parties to provide services to their regulated businesses. The use of related parties is an integral and valid part of many EDBs' businesses, particularly EDBs whose characteristics, such as location or size, mean they may not be able to sustain some services in-house.
15. The EDBs are concerned that problem two suggests some element of bad behaviour on the part of EDBs. The Consultation Paper expresses concern that EDBs may use an unregulated related party to increase overall profits by overcharging for the service supplied by the (unregulated) related party. However, there is no evidence that the related party provisions have been deliberately misused in this way. Rather, the overwhelming evidence is that any misapplication of the rules is due to the poor design of the regime.
16. If perceived or potential bad behaviour becomes the focus of the review, it may lose sight of the need to fix the complexity and inconsistencies present in the current regime, and of the objective to create effective and workable provisions for identifying arm's length prices.

Objective should include a principles-based approach

17. We believe the objective and problem can be broadly summarised, without assigning blame or making assumptions about behaviour, as:
 - the key objective of the related party regime should be the proper identification of demonstrable arm's-length like terms and prices for related party transactions, and

- complexity and inconsistency in the current regime means this objective is difficult to achieve, and may not be being achieved in all instances.
18. One reason for the current regime's complexity is the level of prescription it contains. A key objective of the present review should be the design of a principles-based regime that is adaptive to the individual circumstances of suppliers, avoids prescription and complexity, and allows for the identification of arm's-length prices by suppliers, supported by evidence. Ideally, the policy intent should reflect this objective. We provide more detail about what a principles-based approach might look like later in this submission.

Problems or symptoms?

Some problems are symptoms

19. The Consultation Paper lists a number of separate ‘focus areas’, all of which, except for the issue of ‘imperfect local markets in contracting services’, are really symptoms of the overarching problem of the complexity and inconsistency of the regime. For example, the Consultation Paper points to the increased use of director certification as reducing the transparency of the value of transactions. We believe the increase in directors’ certifications is due to the prescriptive hierarchy of options, and the difficulty of applying any other option to a particular transaction. If a less prescriptive, principles-based regime were introduced, we would expect to see the use of directors’ certifications reduce.
20. This topic was originally included in the ‘complexity and compliance cost’ section of the IM review, indicating the Commission recognised the complexity of the regime, and the fact that meant EDBs had to devote disproportionate resources to compliance. This is a significant issue for the EDBs who support this submission, who often do not have full time resourcing for compliance. The review should remain focussed on resolving the complexity of the regime as a whole.
21. Trying to resolve all these “focus areas” at once risks increasing the duration and complexity of the review. In particular, it risks shifting the focus away from the fitness of the regime as a whole, onto one or two perceived problem areas, which could result in an imperfect tinkering rather than a full regime review. The first step should be to design an adaptive, principles-based regime and then check whether the identified focus areas are likely to still pose any problems.
22. Although the EDBs who support this submission believe these individual issues should not become the focus of the review, we have included a table in Appendix A addressing each of them individually (aside from ‘imperfect markets’, which is addressed below).

Markets lacking access to scale

23. We believe the term ‘imperfect local markets for contracting services’ could be better described as markets lacking access to scale. There is not necessarily anything wrong or ‘imperfect’ in these markets, but their characteristics such as location or size may mean that some services are not readily available at the scale required for the business. The issues with these markets are a matter that cannot be resolved by this review. They are inherent to the sector and in particular to the EDBs who support this submission, many of whom operate within what could be described as markets lacking access to scale for some services. The extent and nature of these markets vary widely, and will depend on characteristics such as location and the type of service in question.
24. EDBs must meet their obligation to provide services to their consumers at the standard expected by the consumers (and the Commission). Related party rules should not operate in a way that would compromise service delivery and should enable EDBs in any market – including those where scale of access is an issue – to recover the fair costs of providing those services.
25. Some EDBs do not have ready access to independent contractors with the level of skill and availability required to deliver services to the standard required. This might be because there are not enough providers of those services in their market, but may equally be because there is so much demand for that service that the EDB cannot guarantee access, when needed, to third party providers at the level of skill and standard required. Some EDBs may not require full-time delivery of those services, meaning an in-house solution may not be the most efficient response. The most efficient way to deliver the services to consumers in those circumstances is to involve a related party that can offer unregulated services to parties other than the EDB.
26. Specific provisions to deal with markets lacking access to scale are unlikely to be of assistance, and may increase the likelihood that EDBs will find compliance difficult. The best approach is to design

and implement a principles-based regime that is adaptive to the circumstances of individual EDBs and the markets in which they operate.

The solution: a principles-based approach

27. Although the Consultation Paper is concerned with problem definition, we believe it is useful to outline a potential solution. As indicated earlier in this submission, the EDBs believe that the problems identified can be resolved by designing and implementing a principles-based, evidence-supported regime for valuing related party transactions, such as that used by the IRD for transfer pricing. Such a regime could be supported by published guidance, which could incorporate elements of the existing regime.

Arm's-length transactions and transfer pricing

28. Tax bodies internationally use transfer pricing to identify the arm's-length value of related party transactions for entities carrying on business in multiple jurisdictions, to avoid under or over taxation of those transactions (in the context of avoiding double taxation).
29. New Zealand's transfer pricing provisions are principles-based and do not impose a prescriptive hierarchy of options. Options are provided for determining arm's-length prices, of which any one or a combination may be used, subject to the following criteria for the choice and application of the appropriate method:
- the degree of comparability between the transactions used for comparison and the transaction being valued;
 - the completeness and accuracy of the data relied on;
 - the reliability of all assumptions;
 - the sensitivity of a result to possible deficiencies in the data and assumptions.
30. The IRD's Transfer Pricing Guidelines² state that they have deliberately avoided using a prescriptive approach:
- “In Inland Revenue's view, such an approach is ineffective. Establishing appropriate transfer prices for tax purposes involved the application of judgement, which will often depend on taxpayers' individual circumstances. Prescriptive guidelines are, therefore, not considered to be a practicable option”*
31. The guidelines are based on key principles, which include:
- transfer pricing is not an exact science, requiring judgement not prescriptive rules;
 - taxpayers know their business best – they know how their prices are set and what the economic and commercial justifications are for the actions they take;
 - the more evidence a taxpayer provides to support the approach taken, the less likely the IRD is to review their transfer pricing in more detail.
32. The EDBs believe the same principles apply to determining arm's-length prices in the context of economic regulation and the Commission should adopt a similar approach for related party transactions.

² Appendix to Tax Information Bulletin Volume 12, No 10 (October 2000)

Appendix A: Problem Definition “Focus Areas”

The EDBs who support this submission believe the individual issues identified by the Commission would be resolved by adopting a principles-based regime and should not become the focus of the review. However, it is useful to provide some analysis for each, both to assist in the evaluation of the problem definition and in the development of the new regime and any guidance developed as part of that regime.

Focus Area	Commission description of the problem	EDB comment
Complexity of terminology	<p>In the context of the design and implementation of the regime, ambiguity is caused by:</p> <ul style="list-style-type: none"> the rules and some terms that are not as well defined as they could be; and some terms used have more than one meaning within the IMs and more broadly. <p>In particular, the term “directly attributable costs” is used in the cost allocation provisions to mean something different. A “related party” is defined in accounting standards but defined differently for the purposes of our regulatory rules.</p>	<p>The term ‘directly attributable costs’ was developed in the context of the cost allocation IM, which is deliberately flexible between directly attributable and not directly attributable costs to enable EDBs to reflect their individual business structures (such as operating models and management accounting systems) while achieving a fair allocation of costs to the regulated service.³</p> <p>The inclusion in the related party regime only of <i>directly</i> (and not <i>not directly</i>) attributable costs creates inconsistent outcomes between EDBs depending on their business structure. For example, the 17.2% margin applies to directly attributable costs but because the costs included in that category differ for each business, the margin may not recover shared costs properly incurred in the provision of their services.</p> <p>The Commission suggests that EDBs may be deliberately structuring their business to achieve a greater combined margin on related party transactions (see Compliance with the prescribed rules in the context of regulated suppliers’ application of the regime, below). While EDB business structures may be resulting in problematic outcomes, it is the inconsistencies in the rules, and not a deliberate effort on the part of EDBs to abuse the rules, that causes these outcomes.</p> <p>The link to ‘directly attributable costs’ should be removed in order to:</p>

³ See the 2010 IM Reasons Paper, paragraphs 3.2.3 and 3.2.25

Focus Area	Commission description of the problem	EDB comment
		<ul style="list-style-type: none"> ensure that related party charges can include recovery of both direct costs and shared costs; ensure related party arrangements are not penalised relative to in-house or external provider models; ensure related party costs are valued consistently with arm's-length prices when qualifying criteria are met; and be consistent with the NPV=0 economic principle which underpins the IMs.
<p>Transparency of the Commission's methodology</p>	<p>The way in which the valuation options are drafted can lead to some regulated suppliers defaulting to the director certification option. This provides stakeholders with limited transparency in assessing whether the transactions are at the equivalent of arm's-length prices and terms.</p> <p>This also raises questions as to the appropriateness of the methodology if directors are not applying the necessary rigour in providing certification.</p>	<p>This issue is caused by the existing prescriptive hierarchy, which results in transactions that do not fit other options defaulting to the directors' certification.</p> <p>The adoption of a principles-based approach, where suppliers have more flexibility in the approach they can use for determining arm's-length prices, would resolve this issue. Moreover, the requirement for supporting evidence as part of that approach would address the transparency issue.</p>
<p>Compliance with the prescribed rules (in the context of design and implementation)</p>	<p>The rules are drafted in a way which has led to some confusion as to which rules apply to opex and capex transactions due to the disconnection of the IMs and ID.</p> <p>In particular, information disclosure still shows some suppliers of regulated services continue to inappropriately apply IM capex rules to opex or vice versa.</p>	<p>The problem is both that:</p> <ul style="list-style-type: none"> the IM and IDD do not align in a simple drafting sense – e.g. the opex equivalent of capex option 2.2.11(5)(a) is included at subparagraph (d) of IDD 2.3.6(1), and terminology and valuation criteria that have substantially the same effect are not always expressed consistently – e.g. directly attributable costs for opex are determined in accordance with the cost allocation IM, but for capex are determined in accordance with GAAP, which does not even recognise the term.

Alignment of these provisions would resolve the issue, but this could be difficult if

Focus Area	Commission description of the problem	EDB comment
Complexity in understanding terminology	Due to the ambiguity of the key defined terms, suppliers have made their own interpretations as to the defining of key terms in the rules, such as directly attributable costs.	<p>the existing level of prescription is retained.</p> <p>A principles-based approach could be applied consistently across both the IMs and ID.</p>
Transparency of the valuation of transactions	<p>Directors' certification has become the default option to use in disclosing the valuation of related party transactions for some regulated suppliers. This results in a lower level of transparency that prices achieved are akin to arm's-length values as there is no visibility in how directors have satisfied that conclusion.</p> <p>In particular, we have seen increased values of related party transactions using director certification in information disclosures and limited or no use of some other valuation options available. There does not seem to be consistent reasoning from EDBs as to the use of this option.</p>	<p>Removing the link to 'directly attributable costs' in the cost allocation IM will resolve this issues as it relates to that term.</p> <p>If there are issues with other terms, such as the inconsistencies between the IM definition of 'related party' and that in GAAP, these may become less significant if a less complex, principles-based approach is adopted.</p> <p>There is nothing inherently wrong with the use of directors' certification, particularly if it is used in the context of a principles-based regime and supported by evidence. The extent of its use in the current regime is a symptom of the regime's complexity and prescription. The issue of transparency relates to the amount of evidence required under the current regime.</p> <p>As noted above, a principles-based approach that requires evidence to support a supplier's determination of arm's-length prices would resolve this issue.</p>

Focus Area	Commission description of the problem	EDB comment
Compliance with the prescribed rules (in the context of regulated suppliers' application of the regime)	The way in which the rules have been drafted has led to some suppliers charging a margin in excess of the 17.2% which was intended to allow for the recovery of overhead costs experienced by the related party. This is either by charging a higher margin and using director certification or by structuring their business in a way to receive a greater combined margin.	As discussed above, it is the existence of different business structures that led the Commission to introduce flexibility in the cost allocation regime, by allowing for 'directly attributable costs' <i>and</i> 'not directly attributable costs'. Not including the latter term in the related party regime means that different business structures result in different outcomes in the context of the 17.2% margin, which only relates to directly attributable costs. It is unfair on EDBs to suggest that they are structuring their businesses to receive a greater combine margin when the problem is a result of the inconsistency between the related party and cost allocation IMs.