ERANZ Submission to the Commerce Commission on the Input Methodologies Review draft decision on Related Party Transactions

27 SEPTEMBER 2017

Electricity Retailers' Association of New Zealand
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1. Introduction

The Electricity Retailers' Association of New Zealand (ERANZ) welcomes the opportunity to submit on the Commerce Commission's (the Commission) Issues paper regarding the Input Methodologies Review draft decision on Related Party Transactions.

ERANZ was established in August 2015 to promote and enhance an open and competitive electricity market that delivers value to New Zealand electricity consumers.

ERANZ represents Genesis Energy, Contact Energy, Mercury, Meridian Energy, Trustpower, Nova Energy, Pulse Energy, Prime Energy, Powershop, Black Box Power, Bosco, Energy Online, Just Energy, King Country Energy, Globug, Grey Power Electricity, Electra Energy, and Tiny Mighty Power, Flick Electric Co., and Wise Prepay equating to around 99% of the market by ICP count.

Related Party Transactions are of interest to ERANZ and its members because cost efficiency across all parts of the sector is a necessary component to keep customer's bills affordable. Furthermore, the impact of related party transactions on the contestable market is a consideration for retailers which operate in a highly competitive environment.

2. Executive Summary

Overall, ERANZ is strongly supportive of the Commission's proposals for amending the related party rules. It is highly appropriate for the Commission to replace the extensive menu of valuation options presently available to regulated suppliers with a more principles-based approach. The proposals will align input methodologies with information disclosures (and therefore align the treatment of operating expenditure and capital expenditure) while also removing a number of complications and ambiguities that may have made interpretation and application of the existing arrangements difficult for regulated suppliers and auditors. The simplified valuation requirements are more clearly linked to the valuation principle which caps related party transaction values at the expected value of an arm's-length transaction. It is important, for the protection of consumers of the regulated services, that related party transactions should not be valued at more than would be the case if the transaction was at arm's-length.

In addition to new, simpler and clearer requirements for valuing related party transactions, the Commission has also recognised that an important check and balance on regulated supplier behaviour is the transparency afforded through information disclosure. The changes to the information disclosure requirements that the Commission is proposing should provide greater transparency and, on an ongoing basis, should help interested parties better assess whether the purpose of Part 4 is being met.

ERANZ believes that the impact of related party transactions between the monopoly regulated service provider and its related parties extends beyond the regulated service. It has the potential to also impact on competitive, or potentially competitive, markets in which the related parties also operate. We do not deny that there can be coordination benefits of using related parties, but the question is whether these net benefits are evident and transparent. Further that the use of related parties does not drive incentives to foreclose or discriminate against equivalent businesses in the contestable market. In light of these concerns ERANZ notes that more formal ring-fencing of the regulated service and a clearer definition of the "regulated service" provides a more holistic and robust solution to the regulation of monopoly services than the current regime does.

However, ERANZ accepts that instigating such a regime change is beyond the ambit of the Commerce Commission and calls on the other relevant regulatory and government bodies to consider the regulatory options more fully.

ERANZ agrees with the Commission that related party transactions are increasing and therefore the risk of harm to consumers is also increasing. Monopoly providers of regulated services have both the means and motive to use related party transactions to increase their overall profitability. It follows that an increase in the volume of related party transactions represent an increased risk of harm to consumers of the regulated service.

Notwithstanding its broad support for the Commission's proposal, ERANZ does have some areas where we think further consideration would benefit the sector and the long-term interests of consumers:

Definition of related party

The definition of 'related party' (and therefore 'related party transaction') remains dependent upon each regulated service provider's own assessment against the definition of what activities are or are not included in the "regulated service". In other words, proposed changes to the definitions of 'related party' and 'related party transactions' will not reduce

regulated supplier discretion and flexibility without there being additional clarity about the definition of the regulated service.

The lack of clarity of the definition has been highlighted by some questioning whether internal legal advice would be regarded as being provided by a related party. The potential that it could be treated as such (perhaps by some EDBs but not by others) highlights the flexibility EDBs would retain when defining what is and what is not part of the regulated service. Again, we appreciate this may be beyond the ambit of the Commission and encourage other regulatory bodies to consider the regulatory options more fully.

Independent assurance report - 65% threshold

The materiality threshold for requiring the independent expert report on related party transactions is set to a very high level. It would seem useful to require additional scrutiny when the level of related party transactions is material relative to the acquisition of a particular service (i.e. a particular market).

Each of the categories included in the proposed/amended schedule 5(b) should be treated as a particular market, with the addition of non-network capital expenditure.

ERANZ proposes that a majority, i.e. more than 50%, is a suitable threshold on a category by category (or particular market) basis. Alternatively (and as a second best approach), where particular markets have not been separately identified, a lower threshold (such as 20%) could be applied to the annual totals of operating and capital expenditures (respectively).

Director certification

ERANZ agrees that the director certification option provides an unsatisfactory level of transparency and the Commission should remain resolute in its determination to remove this ‘valuation’ option.

Map of anticipated network expenditure and network constraints

The benefit of the ‘map’ to interested parties, and in fostering competition and innovation in the supply of services and solutions to the regulated supplier, applies to all regulated suppliers. Accordingly, we contend that the requirement to provide the ‘map’ should be universal and not limited just to those regulated suppliers that have related party transactions. Without forecast ‘maps’ that transparently demonstrate anticipated network

expenditure and network constraints there is information asymmetry about where issues and opportunities lie on said network.

Impact on cost to consumers

ERANZ too is concerned about avoiding unnecessary compliance costs for EDBs that could consequently increase costs for consumers. ERANZ agrees with MEUG that there is a lot at stake given the potential transactions of $360million per annum at risk of being excessively priced or not tested through a transparent competitive procurement process.

In order to avoid incorporating inefficient costs into the regulated service the valuation of related party transactions must effectively operate in such a way that, using the general valuation rule and the value limitation provision, the relevant value is the lesser of actual cost incurred or the arm's-length price/benchmark.

ERANZ proposes that the Commission amend the wording of the value limitation sub-clauses by providing a suitable and clear definition of *"actual transaction price"* or amend the wording of the value limitation sub-clauses to reflect 'actual costs incurred' rather than 'transaction price'.

Assets or services provided to related parties

In relation to transactions from the regulated service provider to the related party, the value limitation provision should limit the 'price' to no less than cost. This will avoid transactions at inefficient prices having an adverse impact on consumers of the regulated service.

Related party transactions in the absence of competitive tender processes

ERANZ notes that MEUG has suggested that the details of all related party transactions that are not sourced in open competitive tenders should be disclosed. There is a clear logic to this approach. ERANZ believes that the Commission should give MEUG's proposal further consideration.

3. Background

As part of its review of related party transactions the Commerce Commission (the Commission) has issued its draft decision (draft decision) for consultation.[1]

[1] Commerce Commission; "Input methodologies review draft decision: Related party transactions; Draft decision and determination guidance"; 30 August 2017

The Commission is undertaking a review of the rules for treating and disclosing related party transactions. This review forms part of the wider review of input methodologies which seeks to ensure that the regulatory arrangements efficiently meet the policy intent as expressed in the purpose of Part 4 of the Commerce Act 1986 ("Part 4").[2]

The risks from related party transactions are not new

Rules relating to related party transactions were included in the original input methodologies established in 2010 and the information disclosure requirements published in 2012. Their inclusion clearly indicates that related party transactions:

- exist or may arise with respect to suppliers of regulated services; and
- regulatory direction is required on the treatment and disclosure of related party transactions to ensure that the policy intent of the regulatory framework is achieved.

The original rules were established to limit the risk of inefficiencies arising and/or to provide for adequate disclosure to allow the identification, by interested parties, of inefficient transactions.

The regulatory rules must continue to deliver the policy intent

The input methodology review is being undertaken pursuant to s52Y(1) of Part 4, which requires that the input methodologies are subject to a review at not more than seven yearly intervals. Such reviews are intended to ensure that rules remain 'fit for purpose' in light of how effective they have been in practice and how they might be expected to perform in light of current and emerging circumstances.

The framework the Commission has established, within which it would make amendments to the existing rules as part of this review, is that rule changes should:

- promote the Part 4 purpose in s52A more effectively;
- promote the IM purpose in s52R more effectively (without detrimentally affecting the promotion of the s52A purpose); or

[2] Commerce Act 1986; s52A

- significantly reduce compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s52A purpose).

That the regulated supplier's input costs should be efficient (as might be demonstrated by an arm's-length transaction) and that efficiency gains achieved by the regulated supplier are shared with consumers of the regulated service are established regulatory principles. It is also implicit that businesses operating in the privileged position of providing essential and monopoly services should be sufficiently transparent to allow consumers and other interested parties to have confidence that privileged position is not being abused. These outcomes are implicit in the purpose of Part 4 and the purpose of information disclosures.[3]

The Commission rightly identifies that *"… there is an onus on the regulated supplier to be able to demonstrate that the cost of the underlying service is efficient and consistent with the input price that it would have paid in an arm's-length transaction."*[4] This observation accords with the original rationale for including related party rules at the commencement of the current Part 4 regulatory regime.

Attributes of competitive markets must be promoted

In addition to growth in the quantum and the relative significance of related party transactions, changing consumer preferences and emerging technologies are poised to stimulate potential new and competitive markets for services. These developments make the need for robust related party rules increasingly important.

Stronger competition, greater innovation and wider consumer choice are all outcomes that would be expected to improve consumer welfare. These attribute should be encouraged and protected where they currently exist or may exist in the future.

Notwithstanding that s 52A(2) provides that, when implementing Part 4, the Part 4 purpose statement (i.e. s52A(1)) replaces the generic purpose of the Commerce Act (set out in s1A) the Commission must be at pains to avoid creating incentives or opportunities for non-competitive outcomes to arise as a result of its Part 4 activities.

[3] Commerce Act 1986; s52A Part 4 purpose statement and s53A purpose of information disclosures .
[4] Commerce Commission; "Input methodologies review draft decision: Related party transactions; Draft decision and determination guidance"; 30 August 2017; para 2.28

If related party transactions may not be replicating the outcomes that would arise from arm's-length transactions (or providing more favourable outcomes) then the Commission is right to consider amending the related party rules.

4. General support for commission's proposals

Overall, ERANZ is strongly supportive of the Commission's proposals for amending the related party rules. It is highly appropriate for the Commission to replace the extensive menu of valuation options presently available to regulated suppliers with a more principles-based approach. The proposals will align input methodologies with information disclosures (and therefore align the treatment of operating expenditure and capital expenditure) while also removing a number of complications and ambiguities that may have made interpretation and application of the existing arrangements difficult for regulated suppliers and auditors. The simplified valuation requirements are more clearly linked to the valuation principle which caps related party transaction values at the expected value of an arm's-length transaction. It is important, for the protection of consumers of the regulated services, that related party transactions should not be valued at more than would be the case if the transaction was at arm's-length.

In addition to new, simpler and clearer requirements for valuing related party transactions, the Commission has also recognised that an important check and balance on regulated supplier behaviour is the transparency afforded through information disclosure. The changes to the information disclosure requirements that the Commission is proposing should provide greater transparency and, on an ongoing basis, should help interested parties better assess whether the purpose of Part 4 is being met.

In supporting the Commission's proposals ERANZ notes that these proposals are constrained by the legislative framework within which the Commission is obliged to operate and also the fragmented nature of regulatory responsibility between the Commission the Electricity Authority (the EA) and the Ministry of Business, Innovation and Employment (MBIE).

ERANZ's broad support for the Commission's proposals is therefore subject, where necessary, to the caveats implicit in the views expressed in section 3 below and the specific comments and suggestions in section 4.

5. Problem definition

ERANZ believes that the impact of related party transactions between the monopoly regulated service provider and its related parties extends beyond the regulated service. It has the potential to also impact on competitive, or potentially competitive, markets in which the related parties also operate. In light of these concerns ERANZ notes that more formal ring fencing of the regulated service and a clearer definition of the "regulated service" provides a more holistic and robust solution to the regulation of monopoly services than the current regime does. We do not deny that there can be coordination benefits of using related parties, but the question is whether these net benefits are evident and transparent. Further that the use of related parties does not drive incentives to foreclose or discriminate against equivalent businesses in the contestable market.

However, ERANZ accepts that instigating such a regime change is beyond the ambit of the Commerce Commission and calls on the other relevant regulatory and government bodies to consider the regulatory options more fully.

ERANZ agrees with the Commission that related party transactions are increasing and therefore the risk of harm to consumers is also increasing. Monopoly providers of regulated services have both the means and motive to use related party transactions to increase their overall profitability. It follows that an increase in the volume of related party transactions represent an increased risk of harm to consumers of the regulated service.

5.1 The problem is wider than regulated services

The Commission's assessment of the potential problems in respect of the related party rules are focussed on the impacts on consumers of the regulated service. However, there remains a wider context in which these risks must be considered. This is the impact behaviours such as those identified by the Commission (see section 3.3, below) may have on:

- the competitive markets which could supply the services that are provided by the related party to the regulated service provider; and

- other markets in which the related party may operate.

In relation to vegetation management services, for example, Asplund comment that *"Contestable procurement processes can also support the development of local markets for providing these same services to the community."* [5]

As ERANZ noted in its submission on the Commission's problem definition paper, it is important that there is a *"…joined-up approach on these matters by the regulatory bodies involved…"*.[6] Beyond the efficient provision of the regulated service there is a potentially significant impact on efficiency at an 'NZ Inc.' level, for example through reduced incentives for innovation. Accordingly, it is important that the efficient delivery of goods and services in markets other than the regulated service is not being frustrated by the way the rules applying to regulated services are working.

To achieve this broader outcome for consumers, we encourage the Commission to work with MBIE and the EA on a first principles review of the regulatory framework. This is an important regulatory role when external forces are changing with inevitable impacts on relegated industries. We note the work in other jurisdictions to establish a stronger sense of the future needs of policy and regulation in this area. Examples are the "Insights for Future Regulation project" launched by Ofgem in 2016 and the Australian Energy Market Commission's (AEMC) "Technology work program". Ofgem's Insights for Future Regulation project aims to ensure, in light of technological and societal changes, that there will be *"a robust and responsive regulatory and policy framework that protects and empowers consumers and encourages beneficial innovation."*[7] AEMC note that their technology work program *"identifies barriers to new technologies; asks whether consumer protections need to be changed; and if the right incentives are in place to support investment and innovation"*.[8] ERANZ encourages similar, broad-based thinking in the New Zealand context.

The importance of a holistic view of the impacts of the changing environment on the regulated industries is highlighted in a study undertaken by MIT.[9] Primary conclusions of this study include:

[5] Asplund; Input Methodologies Review – Related Party Transactions: Invitation to contribute to problem definition / Initial Findings"; 17 June 2017 *[sic]*; pg 2
[6] ERANZ; "Commerce Commission Input Methodologies Review: Related Party Transactions; Invitation to contribute to problem definition" submission; para 6.10
[7] Ofgem; "Ofgem's Future Insights Services - Overview Paper"; pg 2
[8] AEMC website
[9] Massachusetts Institute of Technology; "Utility of the Future - An MIT Energy Initiative response to an industry in transition"; 2016; executive summary

- the need for "[a policy and regulatory] *framework that will enable an efficient outcome regardless of how technologies or policy objectives develop in the future"*; and

- *"the importance of proactive, rather than reactive, policy-making and regulation"*.

Amongst other things, the MIT report identifies that this co-ordinated policy and regulatory approach is needed because:

- *"it is … critical to establish a level playing field for the competitive provision of electricity services by traditional generators, network providers, and distributed energy resources."*;

- *"structural reform that establishes financial independence between distribution system operation and planning functions and competitive market activities would be preferable from the perspective of economic efficiency"*; and

- *"additional measures are critical to prevent conflicts of interest and abuses of market power. These include:*

    - *legal unbundling and functional restrictions on … coordination between distribution system operators and competitive subsidiaries; and*

    - *transparent mechanisms for the provision of distribution system services (such as public tenders or auctions)."*

The scope of such a policy and regulatory review in New Zealand cannot be limited to the monopoly service provider regulations as many of the stakeholders, the necessary innovation and the consumer benefits may exist either outside, or both inside and outside, of that regulatory regime.

5.2 Ring fencing remains the better long term solution

Following publication of the Commission's draft decision, the ENA has said that *"The new commission requirements should end any discussion on ringfencing, which is now totally*

unnecessary. … Any further calls for ringfencing would be opportunistic and clearly designed to restrict the introduction of competition that ultimately gives more choice to consumers".[10]

We do not deny that there can be coordination benefits of using related parties, but the question is whether these net benefits are evident and transparent. Further that the use of related parties does not drive incentives to foreclose or discriminate against equivalent businesses in the contestable market. Contrary to what ENA contends, introducing ring-fencing is designed to stimulate *more* competition and transparency to the supply of network services. Similarly, a clearer definition of what is, and what is not, a related party should stimulate *more* transparent procurement processes and offers from the contestable market. This is what will deliver more choice, and cost assurances, to third parties and consumers.

Throughout the IM review process, it has been a point of contention that regulated suppliers, protecting the position of their regulated monopoly businesses while also seeking to diversify and expand into competitive markets based on emerging technologies, are able to operate in ways that tilt the playing field in their favour. In fact, it is the potential and actual behaviours that are open to regulated suppliers that risk harming competitive markets and associated service innovation. Ring fencing is seen as a viable solution to this risk and is an accepted regulatory tool in many similar jurisdictions (such as Australia).[11]

ERANZ accepts that the Commission is not able to introduce ring fencing as part of the current input methodology review process (because it is outside their policy remit). However, that does not invalidate ring fencing as a legitimate solution to a range of problems with the current regulatory regime. A number of the issues that ring fencing would address, i.e the impacts on markets that are not monopoly markets (as discussed above), fall outside the ambit of the Commission's authority under Part 4 of the Commerce Act. Some such matters, however, do fall within the remit of other regulatory bodies, such as the Electricity Authority and Ministry of Business, Innovation and Employment.

Thus, the real debate on ring fencing (or any alternative solutions to the problem of regulating natural monopolies) is inherently complex and requires concerted consideration by government, all affected regulatory agencies, the regulated industries, consumers and other interested parties. We strongly encourage the Commission to be viewing these issues in a

[10] ENA media release; 30 August 2017
[11] For example, The Australian Electricity Regulator; "AER Ring-fencing Guidelines"; 30 November 2016

holistic sense, and for there to be a joined-up approach across the regulatory agencies on this matter.

The view that this debate needs to be had, in order to deliver a regulatory framework that will facilitate competition and innovation apace with accelerating technological and societal change, is not diminished by the Commission's draft decision on related party transaction rules - just as it has not been diminished by the Commission's decision to tighten the cost allocation rules or resolve its position in respect of emerging technologies. This is because the steps taken by the Commission to date, while in the right direction and with the best of intentions, are limited by the constraints on the Commission's authority and, as such, are band aids rather than holistic and robust solutions.

A significant advantage of ring fencing is that it requires a robust definition of the ring fenced (i.e. regulated) service. As discussed at length during the Commission's review of the impact of emerging technologies, the current service definition for electricity distribution is elusive (if not illusory). A robust service definition would clarify activities that could be provided on a competitive basis (i.e. outside of the regulated activity) and would enable competition to emerge where local conditions make that practical. Ring fencing rules *per se* would not preclude regulated service providers from participating in any such competitive markets, nor accessing the services from those markets.

Regulated suppliers can be expected to resist the concept of ring fencing (or any initiative that levels the playing field) because it reduces their inherent advantage of being able to load costs onto consumers of the regulated service and to cross-subsidise their activities when operating in the competitive market(s).

The impact that the poor definition of the regulated service (in particular in relation to electricity distribution) has on the Commission's related party transaction definition is discussed further in section 4.2, below.

5.3 Discussion of the Commission's problem definition

The Commission has identified that application of the current related party rules may not be consistent with the policy intent underpinning the regulatory framework. The Commission

suggests that this may be due, in part, to the design and implementation of the related party transaction rules and, in part, to the way some regulated suppliers have applied these rules.[12]

More specifically, related party transactions are identified as having the potential to impact the achievement of the Part 4 purpose because:

- an unregulated related party may be used to increase the overall profits of the business group by charging greater than arm's-length prices to the regulated supplier;

- undue weight may be placed on the interests of the related party, resulting in inefficient investment by the regulated service provider, i.e. investment at inefficient levels and/or at inefficient prices;

- there may be a lack of transparency of related party transactions (and potential arm's-length alternatives) making identification of efficiency gains, that ought to be shared with consumers of the regulated service, difficult;

- incentives to innovate may be dampened;

- the quality of the regulated service may suffer if the interests of the related party are favoured.[13]

These potential issues are what necessitated related party rules in the regulations at the outset and the issues have not substantially changed since 2010. What has changed is the increasing proportion of operating and capital expenditures reported as related party transactions and the potential, as a result of changing technology, for this trend to continue. As a result, there is a heightened risk of consumer harm.

The increasing significance of related party transactions within the regulated services, based on the Commission's analysis, was highlighted in the ERANZ submission on the problem definition:

[12] Commerce Commission; "Input methodologies review draft decision: Related party transactions; Draft decision and determination guidance"; 30 August 2017; para 3.3
[13] Commerce Commission; "Input methodologies review draft decision: Related party transactions; Draft decision and determination guidance"; 30 August 2017; para X7

> *"… related party transactions are material and will increasingly become more so. … the total volume and value of related party transactions are proportionately large for regulated services and appear to be growing. In 2012 EDBs spent around $200 million with associated entities. In the year ended March 2016, it was more than $360 million. This represents an 80% increase over that period and the figure is expected to keep rising. It is right for the Commission to be considering this issue in detail."* [14]

Regulated suppliers also confirm that related party transactions are growing in significance. For example:

> The ENA says *"The ENA has conducted its own analysis of the transaction data and agrees with the Commission's assessment of the trends in the consultation paper."* [15]

In short, related party transactions represent a risk of consumer harm and there is general consensus that the quantity of related part transactions and the proportion of related party transactions as a component of each of operating and capital expenditure is growing. There is, therefore, heightened risk of consumer harm.

5.4 An evidential framework - means and motive

Some regulated suppliers have argued that the Commission is heading down the wrong path (or, perhaps, going too far) due to a lack of hard evidence that the adverse behaviours identified in the Commission's problem definition are actually occurring. For example:

> Alpine says *"While in theory an EDB could be using its related party relationships to inflate the costs of services, the Commission provides no evidence that EDBs are doing so. The Commission only provides insight into a theoretical basis on which EDBs could be doing so."* [16]

[14] ERANZ; "Commerce Commission Input Methodologies Review: Related Party Transactions; Invitation to contribute to problem definition" submission; para 5.1
[15] ENA; "Input Methodologies review: Related party transactions - problem definition"; 17 May 2017; para 21
[16] Alpine Energy; "Submission to the Commerce Commission on Input methodology review: Related party transactions - invitation to contribute to problem definition"; 17 May 2017; para 14

> Aurora says *"*[it] *considers that evidence of over-payments is needed to justify tightening of the RPT rules."*[17]
>
> The ENA says *"*[it] *is concerned that the consultation paper overstates the extent of the problem, in particular the suggestion that EDBs may be using the related party rules in a manner which delivers sub-optimal outcomes for consumers. It is not evident that the policy intent is not being met."*[18]

The 'supply side' is also criticised for its inability to penetrate the internal and undisclosed activities that may be occurring within regulated suppliers:

> *"Gentailers still have ample opportunity to provide actual evidence of any problem with RPT rules … if the concerns they have raised are soundly based "* [19]

Whether the potential behaviours identified in the Commission's problem definition are occurring is actually not the key issue. Rather, the critical question for the Commission is: are the extant rules are 'fit for purpose' in controlling and highlighting such activity? It is surely the Commission's core role to identify where regulated suppliers may have the means to cause harm to consumers and, based on its assessment of the risk, to ensure the regulatory arrangements are adequate to mitigate that risk. In its draft decision the Commission has addressed the evidence problem accordingly:

> *"Given the fact that the total volume and value of related party transactions are large and growing, we are concerned that the potential for consumer harm could be significant. However, with the way our current prescriptive set of rules are set out, it is correct that we are unable to conclude whether a large share of the related party transactions meet the arm's-length standard."*[20]

[17] Aurora; "Submission: Input Methodologies Review: Related party transactions - Invitation to contribute to problem definition";17 May 2017; para 14
[18] ENA; "Input Methodologies review: Related party transactions - problem definition"; 17 May 2017; para 4
[19] Aurora; "Submission: Input Methodologies Review: Related party transactions - Invitation to contribute to problem definition";17 May 2017; page 2
[20] Commerce Commission; "Input methodologies review draft decision: Related party transactions; Draft decision and determination guidance"; 30 August 2017; para 3.18

It is clear that, if there is inadequate transparency under the regulatory requirements, compounded as that may be by difficulties in applying the extant rules, then gathering evidence of actual harm to consumers or related markets will be hard.

In any event, the Commission's assessment is that the risk of harm to consumers exists and, with increasing volumes of related party transactions and evolving circumstances, the risk is likely increasing. The Commission also rightly concludes that the extant rules have not proven to be effective in mitigating the risk or in providing the necessary levels of transparency to give confidence that the purpose of Part 4 is being met.

There are some regulated suppliers that accept the Commission must address the potential risk of consumer harm. For example:

> Unison says *"We recognise that there is a legitimate theoretical concern about profit-shifting, which the rules are seeking to address, so Unison accepts that EDBs therefore need to be subject to a suitably rigorous regime, with appropriate levels of transparency."*[21]

> Vector says *"*[it] *recommends a better characterisation of the problem is there being a risk that some transactions may not occur on arm's length terms. … In this respect, the related party rules have the purpose of minimising the risk of related party transactions occurring on terms less favourable to consumers of the regulated service … To the extent the current rules give rise to misinterpretation Vector agrees there is a heightened risk of parties inaccurately applying the related party rules to transactions. We also agree such misinterpretation could give rise to more value being attributed to the service provided by the related party. Where this is the case, Vector agrees the ambiguity in the current rules are not meeting their purpose of minimising the risk of the transaction occurring above arm's length terms. We support clarification of the rules to eliminate this risk."*[22]

However, the risk is not just a theoretical one based on potential (or theoretical) behaviours, i.e. the means, by which regulated suppliers might cause harm to consumers, but is based on regulated suppliers having the motive as well. There can be no doubt that regulated suppliers have incentives to exploit related party transactions in order to increase profitability.[23]

[21] Unison: submission by letter to Keston Ruxton; 17 May 2017; pg 4
[22] Vector; "Vector submission on related party transactions invitation to contribute to problem definition"; 17 May 2017; paras 5, 6 and 18
[23] Regulated suppliers also have the means to embark on practices that substantially lessen competition in the market by not adequately disclosing information, and creating opportunities to favour their own related parties.

Regulated suppliers have a statutory obligation to operate as successful businesses.[24] Although there may be a number of facets to measuring this, the fiduciary duty owed by the directors of regulated suppliers to the shareholders of those businesses must mean that commercial motives, such as profitability and protecting/increasing shareholder value, are of primary significance.

Furthermore, it is implicit in the establishment of an incentive-based price control regime (including elements such as the incremental rolling incentive scheme and financial penalties and rewards for quality performance) that policy makers and regulators also believe that regulated suppliers are strongly driven by commercial motives.

Even in the case of exempt Electricity Distribution Businesses (EDBs) commercial motives cannot be denied. The basis for exemption from price control is not the lack of commercial motives and therefore minimisation of the potential for consumers to be harmed by the pursuit of commercial outcomes. Rather, exemption is based on the assumption that any such harm will be tempered by the same actors (i.e. the consumers) benefiting in their alternate roles as ultimate beneficiary-owners.

Without the appropriate regulatory rules in place around related party transactions regulated suppliers have both the means and the motive to cause harm to consumers of the regulated services. This should be a sufficient basis for the Commission to ensure the related party rules are 'fit for purpose' and to take remedial action if the rules are not effective.

6. Comments on the draft decision

Notwithstanding our broad support for the Commission's proposal, ERANZ does have some areas where we think further consideration would benefit the sector and the long-term interests of consumers:

Definition of related party

The definition of 'related party' (and therefore 'related party transaction') remains dependent upon each regulated service provider's definition of what activities are or are not included in the regulated service. In other words, proposed changes to the definitions of 'related party' and 'related party transactions' will not reduce regulated supplier discretion and flexibility without there being additional clarity about the definition of the regulated service.

[24] Energy Companies Act 1992; s36

Independent assurance report - 65% threshold

The materiality threshold for requiring the independent expert report on related party transactions is set to a very high level. It would seem useful to require additional scrutiny when the level of related party transactions is material relative to the acquisition of a particular service (i.e. a particular market).

Each of the categories included in the proposed/amended schedule 5(b) should be treated as a particular market, with the addition of non-network capital expenditure.

ERANZ proposes that a majority, i.e. more than 50%, is a suitable threshold on a category by category (or particular market) basis. Alternatively (and as a second best approach), where particular markets have not been separately identified, a lower threshold (such as 20%) could be applied to the annual totals of operating and capital expenditures (respectively).

Director certification

ERANZ agrees that the director certification option provides an unsatisfactory level of transparency and the Commission should remain resolute in its determination to remove this 'valuation' option.

Map of anticipated network expenditure and network constraints

The benefit of the 'map' to interested parties, and in fostering competition and innovation in the supply of services and solutions to the regulated supplier, applies to all regulated suppliers. Accordingly, we contend the requirement to provide the 'map' should be universal and not limited just to those regulated suppliers that have related party transactions. Without forecast 'maps' that transparently demonstrate anticipated network expenditure and network constraints there is information asymmetry about where issues and opportunities lie on said network.

Impact on cost to consumers

ERANZ too is concerned about avoiding unnecessary compliance costs for EDBs that could consequently increase costs for consumers.

In order to avoid incorporating inefficient costs into the regulated service the valuation of related party transactions must effectively operate in such a way that, using the general

valuation rule and the value limitation provision, the relevant value is the lesser of actual cost incurred or the arm's-length price/benchmark.

ERANZ proposes that the Commission amend the wording of the value limitation sub-clauses by providing a suitable and clear definition of *"actual transaction price"* or amend the wording of the value limitation sub-clauses to reflect 'actual costs incurred' rather than 'transaction price'.

Assets or services provided to related parties

In relation to transactions from the regulated service provider to the related party, the value limitation provision should limit the 'price' to no less than cost. This will avoid transactions at inefficient prices having an adverse impact on consumers of the regulated service.

Related party transactions in the absence of competitive tender processes

ERANZ notes that MEUG has suggested that the details of all related party transactions that are not sourced in open competitive tenders should be disclosed. There is a clear logic to this approach. ERANZ believes that the Commission should give MEUG's proposal further consideration.

6.1 The Commission's proposal

The Commission's proposed changes represent significant changes to the related party rules. However, these changes are necessary to address the problems that have been identified and reflect many of the solutions broadly outlined by regulated suppliers and other interested parties (including ERANZ).

The Commission has proposed changes to key definitions:

- revising the definition of arm's length transaction to mirror that used in the accounting standard IAS (NZ) 550;
- specifically referring to NZ IAS 24 in the definition of related party, rather than the more general reference to GAAP; and
- amending limb (b) of the related party definition to clarify that parties within a single legal entity can be related parties.

The Commission has also proposed:

- a principles-based approach to valuation which clearly aligns with the policy intent and which will replace the large number of prescriptive valuation options currently available to regulated suppliers;

- improving transparency by requiring regulated suppliers to demonstrate that related party transactions are valued as if they were on an arm's-length basis, using an objective and independent measure (such as competitive price signals or benchmarking); and

- have auditors of information disclosures report against these requirements.

The Commission's approach removes the current drafting complexity and misalignment between the valuation approaches in the input methodologies and information disclosures.

There is also provision for an additional independent assurance report to be required if:

- more than 65% of operating or capital expenditure is provide by related parties;

- the auditor is unable to conclude that the related party transactions meet the related party transactions valuation rule; or

- the auditor issues a modified audit report (although time constraints may mean that the independent assurance report is provided with the following year's disclosures).

6.2 Related party definition is frustrated by poor service definition

The Commission rightly affirms that regulated suppliers should be free to structure their businesses and commercial arrangements in the most efficient ways. Furthermore, these arrangements may differ between regulated suppliers due to differences in the scale and scope of their activities and due to other exogenous factors, such as the effectiveness of market conditions in their geographic area.

Saying that it is appropriate that regulated suppliers should be able to structure their business activities in the most efficient way is vastly different from saying that they should have the ability to define their regulated service with the same breadth of discretion. The flexibility

afforded by the definition of the regulated service complicates and frustrates the Commission's proposed definitions affecting related party transactions.

The Commission's proposed definition of related party is:

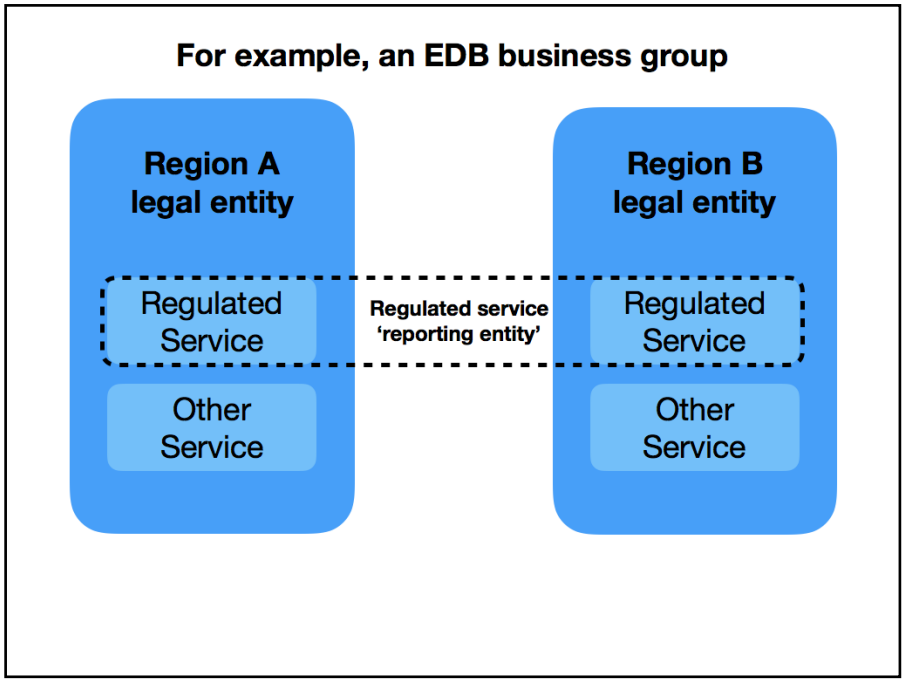
> *"Related party means-*
>
> *(a) a person that is related to the [EDB/GDB/GTB], where the [EDB/GDB/GTB] is considered as the 'reporting entity', as specified in the definition of 'related party' in NZ IAS 24; or*
>
> *(b) any part, branch or division of the [EDB/GDB/GTB] that does not supply [electricity distribution services/gas distribution services/gas transmission services]."*[25]

A key change the Commission has proposed from a definitional perspective is to include the words 'branch or division' in the definition of related party. These words add to the term 'part' in the existing definition in reference to sub-units of the legal entity that are not providing the regulated service but may be providing services to the regulated service.

Essentially, the Commission is trying to clarify that, for regulatory purposes, the 'reporting entity' is that part (or those parts) of the business that provide the regulated service, while other parts of the legal entity may provide other (unregulated) services. To illustrate the point, diagram 1 below shows an EDB that operates in two geographic regions where, in each region, a separate legal entity operates (perhaps as the legacy of a previous acquisition or merger). In each region the business also undertakes another (competitive) activity, for illustrative purposes this might be something such as electrical appliance retailing - so as to be distinct from the regulated service.

[25] Commerce Commission; "Input methodologies review draft decision: Related party transactions; Draft decision and determination guidance"; 30 August 2017; para 4.48

Diagram 1: Regulated services 'reporting entity'



In this example (Diagram 1), the regulated service elements are consolidated and reported together as the regulated service reporting entity for information disclosure purposes. This is the case, even though they exist in more than one legal entity. Furthermore, if one or both 'other service' elements of the EDB provide services to either of the 'regulated service' elements then those transactions would be related party transactions. This interpretation of the reporting entity is unchanged by the Commission's proposed addition of the words "branch or division", although these words may arguably remove some potential areas of doubt.

However, it is not clear how limb (b) of the definition, amended or otherwise, will constrain the flexibility regulated suppliers have when defining what is and what is not part of the regulated service. It seems that the regulated supplier will still have very wide discretion to decide whether an activity provided by a part, branch or division forms part of the regulated service, or not. Therefore, the second limb of the related party definition is unlikely to have any substantive effect and the proposed amendment does not appear to address the legitimate concern expressed by Vector about "selective interpretations".[26]

[26] Commerce Commission; "Input methodologies review draft decision: Related party transactions; Draft decision and determination guidance"; 30 August 2017; para 4.50 referred to para 22 of Vector's "Submission on related party transactions invitation to contribute to problem definition" dated 17 May 2017.

The Commission acknowledges *"the difficulty in interpreting limb (b) of 'related party' in [the] definition …"*.[27] The key problem is that the definition of the regulated service is unclear. The 'guidance' provided in the draft decision does not adequately address the meaning of related party nor the classification of services which should be treated as related party transaction, especially when supplied by a part, branch or division of the regulated supplier entity. Without sufficient clarity the inherent fluidity of the regulated service definition delivers significant discretion to the regulated supplier.

As was discussed in terms of emerging technologies, the Commission's position is that *"assets used to support the conveyance of electricity by line comprise part of the regulated service"* as do services that "[help] *to provide an electricity lines service"*.[28,29] Accordingly, drawing from the example in table 4.4, it is unclear that activities such as *"repairs and maintenance, vegetation management and[/or] minor capex builds"* performed by a part, branch or division of the legal entity would be treated by a regulated supplier as a related party transaction.[30] This would seem to be the case even if the relevant part, branch or division provided these services to third parties as well as the regulated supplier.

ERANZ proposes the following approaches to address the shortcomings in the related party definition:

- The Commission has proposed that the value of arm's-length transactions should be based on objective and independent measures. It follows that the Commission could define related party transactions, in particular those provided from within the legal entity, as being, for example, 'services where competitive price signals or benchmark transaction values are practicably available'. This could be done in a way that aligns with the evidential requirements proposed by the Commission in the general valuation rule.

- Alternatively, the Commission could better and more specifically define the terms "operate the regulated service" and "supply the regulated service", which are included in the

[27] Commerce Commission; "Input methodologies review draft decision: Related party transactions; Draft decision and determination guidance"; 30 August 2017; footnote 70, page 55
[28] Commerce Commission; "Input methodologies review draft decision - Topic paper 3: The future impact of emerging technologies in the energy sector"; 16 June 2016; para 186
[29] Commerce Commission; "Input methodologies review - Emerging technologies pre-workshop paper"; 30 November 2015; para 55
[30] Commerce Commission; "Input methodologies review draft decision: Related party transactions; Draft decision and determination guidance"; 30 August 2017; Table 4.4 (pg 58)

Commission's table 4.4, in such way as to clearly differentiate monopoly service activities from non-monopoly service activities.

6.3 Independent assurance report - 65% threshold

The Commission proposes that in circumstances where related party transactions are a material proportion of the disclosure year's total operating or capital expenditure the supplier of the regulated service would be required to seek an independent report from an independent expert.[31,32]

The materiality threshold is proposed to be 65% of total operating or capital expenditure respectively. The basis for setting the threshold at 65% is unclear but as a component of total operating or capital expenditure seems to set a very high threshold.

It would seem more effective to require the independent expert report when the level of related party transactions is material relative to the acquisition of a particular service (i.e. in a particular market). For example, if a regulated supplier sourced the majority of their vegetation management services from a related party then additional independent assessment of the transactions is warranted to provide the necessary level of confidence to interested parties. This is notwithstanding that vegetation management on its own may be a relatively small proportion of total operating costs.

Each of the categories included in the proposed/amended schedule 5(b) should be treated as a particular market, with the addition of non-network capital expenditure, for the purposes of assessing the significance of related party transactions.[33]

ERANZ proposes that a majority, i.e. more than 50%, is a suitable threshold on a category by category (or particular market) basis. Alternatively (and as a second best approach), where particular markets have not been separately identified, a lower threshold (such as 20%) could be applied to the annual totals of operating and capital expenditures (respectively).

[31] Commerce Commission; "Input methodologies review draft decision: Related party transactions; Draft decision and determination guidance"; 30 August 2017; para 4.37
[32] An independent expert's report would also be required if the auditor is unable to come to an unqualified audit opinion.
[33] [DRAFT] Electricity Distribution Information Disclosure Amendments Determination (No.2) 2017 - Schedule 5b; 30 August 2017

6.4 Director certification

The Commission is right to remove the director certification option.

A number of regulated suppliers have promoted retention of the director certification option.[34] As the Commission has pointed out, the director certification option provides an unsatisfactory level of transparency for users of the information disclosures. Where director certification is relied upon the information disclosures fail to achieve their objective, in relation to the relevant related party transactions, as interested persons are unable to adequately assess whether the purpose of Part 4 is being met.

Directors should have been signing these certificates based on information very similar to that the Commission is now requiring is disclosed or verified by audit. This means that the information on which the proposed disclosures would be based should be readily available.

6.5 Map of anticipated network expenditure and network constraints

The Commission considers that *"… a simplified high level summary of* [planning and implementation of EDB network development projects] *would better enable interested parties to offer new services"*.[35] Providing this user-friendly information in maps recognises that, to the extent similar information may be gleaned from some Asset Management Plans ("AMPs"), the AMPs are more technical and less accessible documents for many interested parties.

Providing this information, in an accessible and user-friendly format, will help the development of innovative alternative options, thus enabling interested parties to determine whether the regulated service is supplied with assets and services at the most efficient input costs. . Without forecast 'maps' that transparently demonstrate anticipated network expenditure and

[34] For example:

- ENA; "Input Methodologies review: Related party transactions - problem definition"; 17 May 2017; para 27;
- Alpine Energy; "Submission to the Commerce Commission on Input methodology review: Related party transactions - invitation to contribute to problem definition"; 17 May 2017; para 16;
- Aurora; "Submission: Input Methodologies Review: Related party transactions - Invitation to contribute to problem definition";17 May 2017; page 7;
- Wellington Electricity; "Input Methodologies Review: Related Party Transactions Problem Definition"; 17 May 2017; pp 1-2

[35] Commerce Commission; "Input methodologies review draft decision: Related party transactions; Draft decision and determination guidance"; 30 August 2017; para 5.32

network constraints there is information asymmetry about where issues and opportunities lie on said network.

It seems that these considerations apply to all regulated suppliers, not just those disclosing related party transactions. For example, while the information provided by Powerco was cited as good model, in the absence of related party transactions Powerco would not be required to continue this disclosure.

The proposed maps should be required not only because of the presence of related party transactions but also because the accessible information is generally helpful to interested parties and will promote innovation and competition generally (i.e. not just where related party transactions may be occurring). Accordingly, this requirement should apply to all regulated suppliers as part of their information disclosure requirements.

6.6 Impact on cost to consumers

ERANZ too is concerned about avoiding unnecessary compliance costs for EDBs that could consequently increase costs for consumers. ERANZ agrees with MEUG that there is a lot at stake given the potential transactions of $360million per annum at risk of being excessively priced or not tested through a transparent competitive procurement process.

The ENA has argued that the proposals in the Commission's draft decision will drive up costs for consumers. They suggest that the need to check related party prices against external market prices or benchmarks will result in prices for the related party services that exceed the actual costs incurred by the EDB. By way of example, the ENA says that: *"If you have in-house legal - that is a lot more economical than outsourcing to lawyers who will charge you 'x hundred dollars' per hour. … If we take this approach, we will have to value those services at arms-length cost, which could be $400 per hour."*[36]

It is not clear why, in the ENA's example, a service such as internal legal advice would necessarily be regarded as being provided by a related party. The potential that it could be treated as such (perhaps by some EDBs but not by others) highlights the flexibility EDBs would retain when defining what is and what is not part of the regulated service. The fact that the ENA can question whether in-house legal services are a related party transaction highlights the very issue with the lack of clarity around the definition. However, the ENA's proposition

[36] Energy News; "Related-party measures will drive up costs for EDBs consumers - ENA"; 1/9/17

also demonstrates that the valuation requirements proposed by the Commission may still be subject to misinterpretation and/or manipulation.

The proposed general valuation rule has attached to it a value limitation requirement.[37] The value limitation provision is intended *"… to remove the opportunity for the supplier of the regulated service to add an additional margin above the purchase price to the transaction when costing it into the cost of the regulated service. This additional margin could result in the regulated service incorporating inefficient costs."*[38]

Table 4.1 in the draft decision is more explicit in saying *"*[t]*he rules will incorporate a value limitation at not more than the cost incurred … ."*

The valuation clauses in the input methodologies and the information disclosure requirements provide for the value of related party transactions to be set on the basis that:

(a) each related party transaction must be valued as if it had the terms of an arm's-length transaction;

(b) the value of a related party transaction must be based on an objective and independent measure; and

(c) notwithstanding paragraphs (a) and (b), the asset value in the related party transaction must not exceed the actual transaction price of the asset.

In order to avoid incorporating inefficient costs into the regulated service valuation of related party transactions must effectively operate in such a way that, using the general valuation rule and the value limitation provision, the relevant value is the lesser of actual cost incurred or the arm's-length price/benchmark.

ERANZ proposes that the Commission amend the wording of the value limitation sub-clauses by providing a suitable and clear definition of *"actual transaction price"* or amend the wording of the value limitation sub-clauses to reflect 'actual costs incurred' rather than 'transaction price'.

[37] Commerce Commission; "Input methodologies review draft decision: Related party transactions; Draft decision and determination guidance"; 30 August 2017; table 4.1 on pg 48 and paras 4.18-4.20
[38] Commerce Commission; "Input methodologies review draft decision: Related party transactions; Draft decision and determination guidance"; 30 August 2017; para 4.19

We also reiterate that the additional cost for EDBs to comply with greater transparency and information disclosure should be manageable given there should be internal mechanisms to assess these contracts for efficiency currently occurring within the governance of EDBs. It is not clear to us why the measures suggested by the Commission would incur a great deal of extra compliance cost.

6.7 Assets or services provided to related parties

ERANZ agrees with the inclusion in the related party transaction value requirements of rules relating to the valuation of goods and services, assets or components of assets provided by the regulated service provider to a related party.[39]

However, in relation to transactions from the regulated service provider to the related party, the value limitation provision should limit the 'price' to no less than cost. This will avoid transactions at inefficient prices having an adverse impact on consumers of the regulated service.

6.8 Related party transactions in the absence of competitive tender processes

ERANZ notes that MEUG has suggested that the details of all related party transactions that are not sourced in open competitive tenders should be disclosed.[40] There is a clear logic to this approach, especially in those cases where EDBs rely upon director certification to meet the current disclosure requirements. Essentially, the information must already be available for the directors to make their decision to certify and, as should most likely occur where there is an absence of a market there should be no commercial sensitivity about such disclosure.

ERANZ believes that the Commission should give MEUG's proposal further consideration.

7. Conclusion

Overall, ERANZ is strongly supportive of the Commission's draft decision. We believe there are areas where the Commission could still go further to ensure the long-term benefit of consumers is sufficiently factored in, particularly the definition of related party, the threshold for an independent assurance report, the need for disclosure of anticipated network

[39] For example: [DRAFT] Electricity Distribution Information Disclosure Amendments Determination (No.2) 2017; clause 2.3.6
[40] MEUG; Input Methodologies review - Related party transactions ;17 May 2017; para 5a

expenditure and network constraints, improvement to the wording of value limitation to avoid impact to consumers, and the disclosure of details of related party transactions that were not competitively tendered.

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 .

Yours sincerely

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