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Input Methodologies review. Related party transactions – problem definition

Submission to the Commerce Commission

Final

From the Electricity Networks Association

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1. Introduction

1. The Electricity Networks Association (ENA) appreciates the opportunity to make a submission to the Commerce Commission (Commission) on the consultation paper **Input methodologies review. Related party transactions – Invitation to contribute to problem definition, 12 April 2017 (consultation paper)**.
2. The ENA represents 27 electricity distribution businesses (EDBs) or lines companies, who provide critical infrastructure to New Zealand’s residential and business customers. Apart from a small number of major industrial users connected directly to the national grid and embedded networks (which are themselves connected to an EDB network), electricity consumers are connected to a distribution network operated by an ENA member, distributing power to consumers through regional networks of overhead wires and underground cables. Together, EDB networks total 150,000 km of lines. Some of the largest distribution network companies are at least partially publicly listed or privately owned, or owned by local government, but most are owned by consumer or community trusts.

2. Submission summary

3. The ENA supports:
 - the Commission objective for the regime to ensure outcomes that reflect arm’s-length transaction values and considers the focus of the rules should be on establishing a robust estimate of the value of goods and services provided by a related party, as if they were a third party.
 - the Commission view that the related party transaction rules can be improved upon to deliver better outcomes for consumers and for EDBs. The consultation paper rightly identifies that inadequacies and/or inconsistencies in the design and structure of the rules may cause implementation issues for EDBs,
 - the Commission view that transparency of related party transactions and values is desirable to provide stakeholders with confidence regarding outcomes but considers that commercial confidentiality may limit transparency in many instances.
4. However, the ENA:
 - 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,
 - considers the related party transaction rules need to be capable of reflecting arm’s-length values of different types of goods or services received by EDBs, and as far as possible, be able to cater for different types of goods and services that may emerge in future,
 - considers that there are adequate incentives on EDBs to use related parties or third parties efficiently, driven in part by the operation of the overall regulatory regime (revenue cap regulation and the IRIS rules), as well as by commercial and ownership imperatives.

3. Overview of Commission consultation paper

5. The consultation paper:

- builds on the initial topic paper¹, based on discussions with EDBs and auditors, and the Commission’s analysis of related party trends and its assessment of the risks if the related party regime does not deliver its intended outcomes,
- restates that the policy intent for the related party regime is to ensure that related party arrangements are valued, and are on terms akin to arm’s-length transactions,
- identifies issues that suggest there may be problems with the outcomes from the current regime, and with the way the regime is working in practice. These issues are that:
 - the regime needs to accommodate both a range of related party structures and reasons for using related party transactions,
 - in aggregate, there is strong growth in the use of related party transactions and, with certain EDBs, in the quantum of services provided by related parties,
 - there is a range of implementation issues with the related party regime, which includes IMs for capex and ID for opex and revenue, that affect outcomes, and
 - limited transparency with the options used to value transactions, where many EDBs use directors’ certification as their default option,
- identifies two problems from these concerns:
 - the design of the regime raises a risk that the policy intent will not be achieved,
 - the implementation of the regime rules by EDBs raises a risk that the policy intent will not be achieved in practice,
- provides an assessment of the materiality of the potential impact on consumers as “medium” when considering a range of areas of impact, and
- puts forward brief initial views on potential solutions.

4. Related party policy and outcomes

4.1. Discussion

6. The ENA agrees with the policy intent as stated in the consultation paper, that is, to ensure:

¹ Commerce Commission, *Input methodologies review draft decisions – Topic paper 7: Related party transactions*, 16 June 2016 (topic paper)

- 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 – as far as is practicable - which may differ from the actual purchase price.²
7. The consultation paper also refers to the policy intent outlined in the topic paper, and to the ENA's submission on the same, which argued that any review process should be conducted at a principled level and start with confirming the desired policy outcomes as *the intention should be to provide for the fair recovery of costs, at arm's-length prices*.³ The ENA notes the Commission's comment on this submission at paragraph 2.61 of the consultation paper. For clarity, our position is that the intention should be to provide for the *recovery of fair costs* at arm's-length prices. Importantly, this would shift the focus of the policy intent from a negative one, with its assumption of bad behaviour on the part of EDBs, to a positive one, seeking fair outcomes for consumers and regulated businesses.
8. As the Commission indicates in the consultation paper, there is no real issue with the policy intent. However, the implementation of the policy intent needs some improvement. The Commission recognised early in the IM review process that the primary issue with implementation is the complexity of the regime⁴, and the ENA believes the current review should focus on resolving that complexity and the inconsistency between opex and capex rules.
9. In our previous submission on the topic paper, we noted that it appeared the Commission's review was focusing on a few particular issues that had been identified either by the Commission or submitters. The Commission's subsequent work on this subject appears to have maintained a focus on these issues but has now scoped them as material problems that require resolution. Given that the Commission has not presented evidence in support of their changed scope, the ENA believes this approach risks introducing complexity to the problem definition.

4.2. Recommendations

10. The ENA recommends that:
- the starting point for the review of the related party regime should be the principles for the related party rules and the outcomes they are intended to achieve,
 - the objective should be to provide for the recovery of fair costs, at arm's-length prices, with consistency between EDBs and transactions based on evidence wherever possible, and

² In reviewing related party transaction rules however, care needs to be taken to avoid imposing an unrealistic standard for valuing transactions.

³ ENA, *Input Methodologies review – Topic paper 7, related party transactions: Submission to the Commerce Commission*, 4 August 2016 (previous submission)

⁴ The ENA was asked by the Commission to present on related party issues as part of the "complexity and compliance costs" part of the IM review forum on 29 and 30 July 2015

- the focus should be on resolving complexity in the rules to drive better outcomes, rather than focussing on individual symptoms of the problem in isolation.

5. What problems?

5.1. ENA assessment of the situation

11. The ENA believes the key issue is how to provide a clear and consistent method for establishing arm's-length prices. The ENA considers the best way to achieve this is to use a principles-based approach, supported by market evidence. Similar principles-based approaches are applied under GAAP and by the IRD in the context of transfer pricing.
12. Currently, the regime is complex and inconsistent. Many of the issues identified in the consultation paper are symptoms of implementation issues associated with an inadequate regime. If the complexity and inconsistency of the current regime can be resolved, many of the identified issues should also be resolved. Moreover, if the rules for valuing related-party transactions are effective in identifying arm's-length values, any concerns about efficiency, such that they exist, should diminish as the incentives created by price or revenue cap regulation for EDBs to be efficient will extend to ensuring EDBs are seeking efficiencies from their related parties.
13. The related party regime in Australia faced similar issues that were resolved by taking a "benchmarking" approach to the effectiveness of the related party rules and the perceptions of inappropriate transaction valuations disappeared.

5.2. The problem as defined in the paper

14. The ENA broadly agrees with the problem identified in paragraphs 4.2 of the consultation paper. However, it considers a better description of the broad problem is that:

“The current practical application of the related party provisions *could be improved to better align with the policy intent.*”
15. As to the two 'sub-problems' in paragraph 4.3, the ENA submits that the Commission should acknowledge that the second of these (4.3.2), concerning issues with application of the rules, may well be a consequence of poor design and is not necessarily a reflection on the capability or attitude to compliance of suppliers, as 4.3.2 implies. The risk that is identified as problem one (4.3.1) is therefore not a problem but merely a consequence of the broad problem above.
16. The Commission's assessment of the problem in Tables 4.1 and 4.2 of the consultation paper is useful in identifying the factors contributing to the issues currently experienced in implementing the related party regime. However, the ENA is concerned that the volume of issues expressed in the consultation paper risks overstating the extent of the problem.
17. Aside from the issue of imperfect local markets, the problems identified in the tables all relate to the fact that the current regime is complex and inconsistent. As noted above, the ENA considers this to be the primary issue with the related party regime, rather than any behavioural issues.

Drafting, alignment and application issues

18. The Commission has an early view that problems exist with the way the related party rules are written and that there is a material risk of consumer outcomes being adversely and materially impacted. ENA members agree that the rules can be improved on but disagree that the current rules adversely impact consumers.
19. The consultation paper acknowledges submissions that the related party provisions in the IMs and in the Information Disclosure Determination could be better aligned. The ENA considers that making these provisions consistent (e.g. in terms of sequencing, terminology and criteria) should be the primary objective of the current review.
20. The complexity of the current regime has resulted in a greater use of the directors' certification than was intended by the Commission, but this occurs primarily because of inconsistency in the rules between related party opex and capex, and/or that the other rules do not provide for a reasonable recognition of the value of goods or services provided by related parties. The ENA does not consider that directors' certification is of itself a problem. The associated issues identified by the Commission, such as lack of valuation transparency, can be resolved by addressing the issues currently experienced in the application of the present regime.

Trends in related party transactions

21. The consultation paper notes the value of related party transactions has been increasing. In the 2016 topic paper, the Commission expressed the intention to examine related-party trends to discover whether they revealed any problems with the regime. 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. That is, the trends merely indicate the extent of the potential impact if the regime is not operating properly, and do not display any inherent problems with the use of related-party transactions.

Imperfect markets

22. The ENA acknowledges that imperfect markets are a characteristic of the sector. These may have driven EDBs to establish related parties to provide services. However, they are not a problem that can or should be resolved in the current review. For example, in smaller regional markets there may only be enough work to sustain a single depot, and it is expensive to maintain a contestable market as it may result in low utilisation or excessive payments to cover out-of-town travel costs. The Commission cannot solve that problem through related-party transaction rules.

Stakeholder submissions

23. In Table 3.2 the problem definition paper offers a summary of stakeholder submissions from the IM review process, as well as the Commission's key observations on stakeholder views. The issues raised by Asplundh, Contact Energy and ERANZ are policy issues associated with the ability of EDBs to efficiently manage their resources and of their efficient procurement. The ENA suggests that, provided the related party rules are sufficient to prevent excess profits being transferred into the related party, then EDBs should have incentives to manage their affairs efficiently.
24. We also make the following observations about the stakeholder views expressed in Table 3.2.

- The Asplundh submission is framed by their interest in vegetation management. They cite variations in the approach of EDBs to the use of external contractors or related party contractors for vegetation management. This is to be expected, because of the diversity of the needs of the different EDB's to vegetation management. Some EDBs have significant forests in their area while other EDBs are largely urban or suburban and will likely handle vegetation issues in other ways. Also, it is not appropriate to quote examples of cost savings from the use of external contractors when the industry and the conditions of the comparison are not referenced.
- The focus of the ERANZ submission was on ring fencing of storage (network and not network batteries), rather than on related party transactions per se. They cite different approaches internationally, such as in California, where structure and rules are in place to regulate the involvement of power companies in storage markets. It is worth noting that power companies in California are vertically integrated and that industry structure has a big influence on market behavior. Because of this, different regulatory rules are to be expected.
- The Contact submission is concerned with the impacts of emerging technology and the participation of EDBs in new technology markets. Contact argues that the related party IM rules are a better option for managing this transition than the cost allocation IM rules. They also suggest that various related party transaction valuation methods may be problematic in the new environment. We agree with Contact and the Commission that the relationship between related party rules and the new technology environment is unclear but we are unable to comment further as the environment is only starting to take shape.

5.3. Recommendations

25. The ENA agrees that the Commission has properly recognised that there is a problem with the design of the regime that is adversely impacting on its implementation. However, the ENA considers that the Commission may be focusing too much on consequences or symptoms of the design problem, as problems in themselves. The ENA submits that the focus of the review should be to improve the related party transaction rules to provide more consistency and reduce complexity.
26. That the Commission focus on improving the effectiveness of the rules for valuing related party transactions to ensure there are suitable options that can be applied to different goods and services that are being supplied to EDBs, in particular by:
 - adopting a more principled approach to defining rules for related party transactions, supported by guidance as to the nature of acceptable evidence, as opposed to prescribing a hierarchy of prescriptive valuation options.
 - improving alignment between capex, opex and revenue rules, and
 - ensuring criteria, sequencing and terminology is fit for purpose.
27. Some specific examples we have provided in previous submissions suggested that:

- the term ‘directly attributable costs’ as it applies to related party transactions inappropriately links cost allocation requirements and related party transactions and this link should be removed,
- the directors’ certification option should be retained as an acceptable option. Directors still need to receive evidence with which to satisfy themselves that they are certifying a reasonable estimate of the value that would be payable to a third-party,
- the IM and information disclosure determination related party requirements should be aligned, and
- the rules need to ensure commercial sensitivity – a potential test for public disclosure is whether similar information is transparently available in the market.

However, these are examples only and a fuller analysis can be provided later in the review process.

Appendix

The Electricity Networks Association makes this submission along with the explicit support of its members, listed below.

Alpine Energy
Aurora Energy
Buller Electricity
Centralines
Counties Power
Eastland Network
Electra
EA Networks
Horizon Energy Distribution
Mainpower NZ
Marlborough Lines
Nelson Electricity
Network Tasman
Network Waitaki
Northpower
Orion New Zealand
Powerco
PowerNet
Scanpower
The Lines Company
Top Energy
Unison Networks
Vector
Waipa Networks
WEL Networks
Wellington Electricity Lines
Westpower