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Dear Keston,

Unison 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). We have also read and support the submission prepared by the Electricity Networks Association.

We understand that the Commission primarily wishes to receive feedback on whether it has defined the "problem" with the related party transaction rules appropriately. In Unison's view, the focus of the review should be on developing a set of consistent, workable set of related party transaction rules, which can be applied in reasonable manner to achieve the Commission's stated policy objective.

In Unison's view there are three main problems with the current rules:

1. Inconsistency between the opex and capex related-party transaction rules;

2. The rules are too prescriptive in some areas. As a result, they do not easily allow for the range of goods and services that an EDB may procure from a related party or the structure of arrangements; and

3. The rules need to be future-proofed given the changing business environment for EDB's, particularly in relation to use of technology.

We provide more detail on the problems identified above in the following sections:

Inconsistency between the opex and capex related-party transaction rules

The following table sets out the related party valuation rules that apply across opex and capex:

Approach	Capex work	Opex work
Arms-length equivalents		
• **Price is similar to substantially similar works in past three years adjusted for inflation**	✓	✓
• **Competitively tendered**	✓	✓
• **Market value**	✓	×
• **Direct cost plus 17.2%**	×	✓
• **Director certification that prices are as would be in arm's length transaction (as last resort)**	✓	✓
Cost-based methods		
• **Inventory value**	✓	×
• **Depreciated historic cost**	✓	×
• **Direct cost (as if consolidated)**	✓	×
•		
• **Nil value if no other option can be exercised**	✓	✓

The table highlights the challenges faced by EDB's in applying the rules, particularly where a related party provides a mix of opex and capex work. In Unison's case, we use the consolidation option to value the services provided by UCSL, Unison's field service contractor. Although this is not strictly permitted by the rules, Unison has applied this approach based on a letter of comfort from the Commission that the overhead costs of UCSL used to provide its services can be included in the consolidation. A simple solution would be to provide for consolidation across opex and capex, per the Commission's letter to Unison.

From Unison's perspective, the value of the services provided by UCSL would be better reflective of the transaction values that would occur under an arm's length arrangement if the "direct cost plus mark-up" approach could apply across both opex and capex. In an external contracting arrangement, a contractor will apply a mark-up to opex and capex to cover overhead costs, and profit requirements. In Unison's case, around one-third of all work is opex and two-thirds capex, so if Unison outsourced this work to a third party, two-thirds of the overhead costs of the contractor would normally be capitalised into the RAB and recovered progressively over time. However, because the only workable way of recognising the costs of UCSL's work for Unison is to consolidate, this means that all of the overhead costs of the contractor are recovered as opex, which therefore raises prices to consumers in the short term. It also affects the comparability of Unison against EDBs who procure field services from a third party.

It is unclear why a market value determined by an independent valuer could not be applied to opex work.

Too much prescription

The direct cost plus mark-up approach for electrical contracting services applies a fixed 17.2% mark-up, regardless of the nature of the service provided or the arrangements. In Unison's case, UCSL engages its own people and has its own equipment and fleet to carry out the works. Unison provides at "free issue" all materials required for works on the basis that Unison wants all its contractors to used standardised materials (e.g., poles, conductor, switches) on the network and to achieve scale economies in procurement. Had Unison adopted the mark-up approach (which is impractical given the inconsistency between opex and capex), it would have been incentivised to have its contractor provide materials, because it could then apply a 17.2% mark-up on the materials, and even go to the extent of leasing vehicles on a job-by-job basis so these could be claimed as direct costs against a job to enable the earning of a 17.2% mark-up. Therefore the use of a fixed mark-up, which does not take account of the structure of arrangements, could in theory lead to a perverse set of incentives to ensure as much cost as possible can be directly attributed to particular jobs.

Following the original publication of the related party IM's we also carried out research into the companies that made up the benchmark used to calculate the 17.2% mark-up. It was evident that these businesses had a variety of different practices, including different approaches to leasing equipment for particular projects versus owning specialist equipment, and therefore had different measured mark-ups because the composition of direct costs differed between companies.

In Unison's view a prescribed mark-up is inappropriate because it applies an implicit universal business model for the provision of electrical contracting services. We believe that the Commission should consider providing for a flexible mark-up, with a requirement on businesses to source an independent report on appropriate mark-up relevant to the business circumstances. Unison also submits that the direct cost plus mark-up approach is an important option that should be available for valuing transactions, particularly in circumstances where a related party electrical contractor is providing services to multiple parties.

Related party transaction rules may not be future-proof

EDBs are increasingly using sophisticated technologies, data analytics, network management systems etc to run their networks. As part of Unison's smart-grid initiative, we have developed a set of software tools that are likely to have commercial value to third parties. These tools have high levels of intellectual property (IP) (intangible value) and lower tangible value. In order to commercialise the tools, it may ultimately prove necessary to place these tools into a related party to provide assurance to third parties purchasing these services that confidential information about their networks is ring-fenced from Unison. There are also the normal commercial reasons for establishing a separate company structure to sell such services (e.g., bringing on other commercial partners).

Unison submits that the related party-transaction rules need to be capable of recognising the ways in which services with a high IP content are priced in the market. While the "market value" approach may be a suitable option if extended to opex, the ability to use this option may not always exist, particularly, during a start-up phase, when the products are first offered to market.

Closing comments

Overall, Unison submits that the focus of this review should be on ensuring a consistent workable set of related-party transaction recognition rules that can address the wide variety of services that an EDB may procure from a related party. 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 (subject to affording businesses the same level of commercial sensitivity as a third-party provider).

We note that some stakeholders have argued that the Commission should use the input methodology rules to achieve structural outcomes (e.g., mandate that EDBs can only procure battery services through third parties or related parties, or require outsourcing of particular services like vegetation management). Unison submits that structural regulation is not an appropriate function of input methodologies, which should avoid having an effect on efficient business structures. In developing the revised cost allocation rules during the broader IM review, the Commission determined that it is not the role of input methodologies to impose particular industry structures, but that this is a policy issue for MBIE. Unison endorses the Commission continuing with that approach.

Yours sincerely,

Nathan Strong
GENERAL MANAGER BUSINESS ASSURANCE