



# **Consultation on Electricity and Gas Input Methodology Determination Amendments 2012**

**Unison Networks Limited**

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## **1 OVERVIEW**

1. This submission addresses the Commission's *Consultation on Electricity and Gas Input Methodology Determination Amendments 2012* ("Consultation Paper").
2. This submission focuses on the Commission's proposals for changes to the asset valuation input methodology in respect of related party asset acquisitions.

## **2 CONSULTATION PROCESS**

3. The Commission has focussed this consultation on an input methodology ("IM") to deal with the treatment of related party asset acquisitions. The paper does not explain the Commission's broader approach to related party transactions, which according to Commission Staff will be dealt with in the forthcoming consultation on Information Disclosure. In telephone conversation with Commission Staff, Unison urged the Commission to issue further guidance on how this consultation fits into the broader context of the various types of related party transactions, but the Commission has elected to provide no further information. Accordingly, this submission responds to the Commission's proposed changes to the Asset Valuation Input Methodology as described in the consultation paper only. We do, however, note that, if it is the Commission's intention to address all the different circumstances in which related parties are involved in contributing to assets that form part of the regulatory asset base, then the present consultation process is too narrow in scope.<sup>1</sup>
4. As a general comment, Unison found the Consultation Paper lacking a degree of transparency about the Commission's analysis underpinning the proposals. For example, there is no discussion of why the Commission settled on the 1%, 20% and 75% thresholds for its safe harbours, or the Commission's response or evaluation of previous submissions on related party transactions, with the Commission simply restating what these submissions were (paragraphs 44 to 53). We submit that this severely undermines the effectiveness of the consultation process, as it leaves submitters in the dark as to the reasons as to why the Commission has rejected previous arguments (was the analysis or justification insufficient; did the Commission take a different view, would further evidence have assisted the Commission?). We think it would be useful for the Commission to develop and consult on a Consultation Charter, whereby the Commission establishes a best practice approach to consultation, as well as explain the expectations it has for submitters.

## **3 UNISON'S UNDERSTANDING OF THE COMMISSION'S PROPOSAL**

5. We understand that the Commission's intention is that:

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<sup>1</sup> For example, as described in Unison's submission on the Information Disclosure Draft Reasons Paper consultation, Unison's contractors provide only labour elements in the construction of assets.

- a) Where an asset is acquired from a related party;
- b) If the value of related party asset acquisitions does not meet certain criteria or requirements set out in proposed clause 2.2.11 (5), then the asset is to be valued at either:
- (i) Its depreciated historic cost in respect of the related party determined by applying GAAP as on the day before the acquisition by the EDB provided sufficient records are obtained and are elected to be relied on by the EDB to establish this cost;
  - (ii) its market value as at its commissioning date as determined by a valuer; or
  - (iii) in all other cases, nil;
6. The criteria in clause 2.2.11 (5) are as follows:
- (5) An asset referred to in subclause (1)(g) is that for which-
- (a) its cost, aggregated with the cost of all assets acquired from any **related party** which are first **commissioned** in that **disclosure year**, is less than:
    - (i) one per cent of the sum of **opening RAB values** for the **EDB** for that **disclosure year**; or
    - (ii) twenty per cent of the aggregate cost of all assets first **commissioned** by the **EDB** in that **disclosure year**; or
  - (b) a certificate is completed by no fewer than 2 of the **EDB's directors** in the form prescribed by an **ID determination** attesting to the fact that:
    - (i) the asset was acquired from a **related party** for which at least 75 per cent of the **related party's** sales of assets are made to parties other than the **EDB** and the price charged to the **EDB** for the asset by the **related party** is demonstrably the same in all material respects as the price charged by the **related party** to those other parties;
    - (ii) the price charged to the **EDB** for the asset by the **related party** is, in all material respects, demonstrably the same or less than the price (adjusted for inflation) paid for assets of a similar type that have been acquired by the **EDB** within any of the preceding 3 **disclosure years** from a party that is not a **related party**;
    - (iii) the price charged to the **EDB** for the asset was determined in accordance with the lowest conforming tender received by the **EDB** in an open competitive tender process; or
    - (iv) documentation exists which is sufficient to demonstrate objectively that the price charged to the **EDB** for the asset is equivalent to that which would be expected under an **arm's length transaction**.
7. The intent of the proposal is to ensure that there is confidence that assets acquired from a related party are no more than that which would occur had the transaction been completed with an independent party. The proposal addresses the concern Unison raised in January 2011, that it would be required to use depreciated historic cost when purchasing transformers from its related party subsidiary ETEL, even though it was possible to establish that the prices Unison paid were market rates.

8. The Commission notes that there are a number of practical implications of the approach in paragraph 39:

39. Some important practical implications of the proposed approach above are that:

- the materiality thresholds (for example, falling below an aggregate transaction value for related party asset acquisitions) means that the effort required to provide assurance over an arm's length equivalent valuation is commensurate with the materiality of the amounts involved
- affected suppliers can potentially avail themselves of several alternative options depending on their specific circumstances. The existing option for relying on related party cost information has been retained, recognising that this data is often available in practice for wholly-owned or controlled entities
- all of the alternative options rely to various degrees on the existence of objective and verifiable facts or information (for example, confirmation of previous outsourcing arrangements or an open competitive tender process) to support the value for the transaction
- the option for adopting a nil value in all other cases will incentivise a supplier with a material amount of related party transactions to take the steps necessary to avail itself of one of the other options.

9. The Commission proposes that the amendments should come into effect upon publication as a notice in the Gazette. We presume that this means that from the date of gazetting the change, the new rules will apply prospectively to commissioned assets.

#### **4 UNISON'S RESPONSE**

10. Unison has contributed to and supports the ENA submission.

11. Unison made submissions on the Commission's proposed treatments of related party transactions in the Commission's consultation on the draft Information Disclosure Requirements.<sup>2</sup> We expressed concern that the Commission was seeking to regulate related party transactions by way of applying a fixed mark-up on direct costs, where particular thresholds or criteria could not be met. Unison's concern arose from the fact that there were a wide variety of related party transactions and a fixed mark-up would not reasonably apply across the range of circumstances. This fixed-mark-up approach is not directly addressed in the "Prior Work and Submissions" section of the Commission's consultation paper<sup>3</sup>, but we assume that the Commission has concluded it would not be a reasonable approach to adopt, at least in respect of related party asset acquisitions where an EDB cannot meet the criteria in clause 2.2.11(5). We assume that the Commission has

<sup>2</sup> Unison (2012) *Submission on Information Disclosure Requirements for Electricity Distribution Businesses and Gas Pipeline Businesses – Draft Reasons Paper*, 9 March 2012

<sup>3</sup> For unstated reasons, the Consultation Paper omits discussion of clause 7.2.2 in the Draft Commerce Act (Electricity Distribution Services Information Disclosure) Determination 2012

proposed a market value approach in place of a fixed mark-up to address concerns about a one-size-fits-all mark-up approach.

12. Unison has the following comments to make about the various aspects of the Commission's proposals:

- a) We welcome the proposed change which specifically addresses the concern raised in our January 2011 letter to the Commission, that we would be required to use a depreciated historic cost approach when objective market value information was available on the value of transformers.
- b) The general framework for valuing assets acquired from related parties is reasonable. The Commission proposes to exclude transactions that meet thresholds for materiality, or where objective evidence can be provided of comparability to market values;
- c) We agree with the ENA submission that there should not be the possibility of 'nil values' being recorded where market values or depreciated replacement cost valuations cannot be established;
- d) The Commission has not consulted on the basis for the proposed "safe harbour" thresholds, or responded to the submissions the Commission notes at paragraph 52 of the Consultation Paper. It is therefore impossible to comment on the reasons for the proposed 75% threshold for contracting with unrelated parties, or why 1% of RAB value or 20% of commissioned assets in the year are appropriate safe harbours. We submit the Commission should release for consultation its reasoning in respect of these values;
- e) Market valuations. Unison agrees that market valuations are a reasonable approach to use where an EDB cannot meet the criteria in clause 2.2.11(5). We assume that the Commission will deal with the mechanics of how the IM would apply in the forthcoming Information Disclosure Determination, but it is unclear from the Consultation Paper whether a market valuation would be required in respect of each transaction. This could potentially be an "administrative nightmare" if there were a large number of transactions that this applied to. Unison submits that where an EDB has an agreed schedule of rates with its related party contractor, if a valuer were satisfied that the agreed schedule of rates were consistent with market value, then that the whole class of transactions should be considered of market value, rather than having a requirement for a valuer to value each transaction separately. This would ensure EDBs can manage compliance costs of obtaining valuations to reasonable levels;
- f) It is unclear whether the Commission has sought feedback from potential valuers prior to issuing these proposals, but it would be necessary to ensure that there is sufficient valuation expertise and knowledge in respect of electricity distribution assets to ensure that the market value approach is workable from commencement of the IM. Otherwise distributors face the risk that related party transactions are recognised at depreciated historic cost only, thereby preventing related party

contractors from covering their fixed overhead costs, which would be an unreasonable outcome, which would be inconsistent with the Purpose of Part 4.

- g) It is possible that such valuation expertise and/or knowledge may develop only in response to the Commission's new requirements. The extent of this risk depends on what the Commission would require from valuers in certifying whether transaction values are consistent with market value. Unison submits that the Commission needs to outline its proposal for the standards required of a valuer, and consult on this before finalising the Input Methodology. A transition approach may be needed, which Unison submits should be for enhanced disclosure regime for an interim period as described in paragraph 127 of the ENA submission on the Draft Information Disclosure Determination;
  - h) We note and endorse Orion's submissions in respect of the thresholds that apply to related party transactions and the concerns expressed about the requirements for any tendering process at paragraphs 44 to 66 of its *Submission on Information Disclosure: Requirements for Electricity Distribution Businesses Draft Determination and Draft Reasons Paper*. Again it would have been helpful for the Commission to have released its reasoning in respect of Orion's previous submission; and
  - i) We agree that the form of Director Certifications should be left for Information Disclosure Determinations.
13. Overall, while we accept the general framework of the proposed approach to related party asset acquisitions, we are concerned about the workability of the Commission's proposals, particularly where market valuations may be required. It will be important that the Commission test its proposals (at the level of how it would practically apply) with auditors and valuers before gazetting the IM.