

17 May 2017

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Dear Keston,

Vector submission on related party transactions invitation to contribute to problem definition

1. This is Vector's submission on the Commerce Commission's (Commission) Input Methodology (IM) review related party transactions – invitation to contribute to problem definition (Problem Definition Paper) published on 12 April 2017.
2. Vector's contact person for this submission is:

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3. No part of this submission is confidential.

Vector's operating model

4. The Vector operates its networks using third party field force contractors for network management services. Some specialised services on our network are delivered by related-party service providers with expert capability such as vegetation management and communication services. We are certain these services are provided on arm's length terms and can withstand scrutiny to verify the case.

The problem definition

5. The Commission's Problem Definition Paper suggests there is an inherent bias for related party transactions to not occur on arm's-length terms. However, Vector recommends a better characterisation of the problem is there being a risk that some transactions may not occur on arm's length terms.

6. 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 than creating barriers for such transactions. The existence of the related party rules regime acknowledges there are public benefits from related party transactions. The related party transactions enable suppliers to procure the most efficient combination of internal and external inputs to deliver the regulated service.
7. The related party transaction rules enable regulated suppliers in seeking efficiencies to have the flexibility to consider both in-sourced and out-sourced models for the required network service. Having such flexibility is in the long-term benefit of end-users as suppliers will deliver the regulated service using the optimal combination of third-party inputs and in-source capability. Effective related party rules ensure this optimum is not skewed by an ability to manipulate terms for inputs to the regulated service beyond arm's length transaction terms.

Types of related party transactions

8. The Commission's research into related party transactions found three types of services commonly provided by related parties: contracting services (including first response, new build, routine maintenance and vegetation management), corporate services and communications services. Given the varying scale of electricity distribution businesses (EDBs) across the country it is not surprising the types of services being acquired from related parties are inputs for the regulated electricity service.

Reasons for related party transactions

9. At the same time, the Commission's research found two common reasons for EDBs relying on related party transactions being "imperfect markets" and "economies of scale". These reasons are grounded in logic consistent with maximising the welfare of the regulated service consumer.
10. The Commission described imperfect markets as the challenge some regions have in attracting third party contractors to provide network services for their region. In such instances the option for in-sourcing enables the regulated supplier to avoid being captive to a third-party supplier.
11. Attaining economies of scale where functions across a broader corporate group are supplied to the regulated business also highlights an interest in leveraging internal capability rather than having to contract for external services. Unnecessary external contracting creates

inefficient transaction costs in negotiation/tendering, contracting and B2B systems and processes.

12. Both reasons are valid and concern the judgement necessary to ensure the optimal resources and minimal transaction costs are involved to deliver the regulated service.

Trends in related party transactions from information disclosures

13. The Commission's Problem Definition Paper identified a "growing" trend for related party transactions for EDBs. The trend is observable at the absolute value of related party transactions and as a percentage of expenditures. Nonetheless, Vector is concerned that trends in related party transactions are being used as evidence of a problem with related party transactions requiring regulatory intervention.
14. There could be several explanatory causes for a rising transaction trend over the four-year period. They could include scarcity of skilled labour (i.e. with parties with in-sourced field forces this will be affected by fibre-to-the-home rollout and Christchurch rebuilding); regional growth increasing work volumes (more demand for the in-sourced field force); level of service required (i.e. vegetation regrowth increasing tree-trimming activity over a period) or growing in-house capability substituting for third-party services.
15. Each of the above explanations will contribute to a rising trend of related party transactions due to more demand or external pressures on the costs for the in-sourced input. However, it does not automatically flow that this is causing customer detriment. Rather, where such external influences exist it will result in more cost for inputs supplied by related parties and show the relative cost of such services to total expenditures growing. In-sourcing or out-sourcing in such circumstances will not change the outcome for consumers. These trends will be captured irrespective if an input is provided by a related party or third-party supplier.

Interpretation of the current related party rules

16. The Commission's Problem Definition Paper recognised the implementation of the current related party rules has caused misunderstanding and varying interpretations of key concepts. The Commission stated several parties to the IM review noted the difficulty with interpreting concepts for valuing transactions such as "directly attributable cost."
17. In addition, parties have acknowledged their difficulty in navigating the different rules in the Commission's *Information Disclosure (ID) Determination* for valuing related party transaction services and the rules in the *Input Methodologies (IM) Determination* for valuing assets commissioned from a related party.

18. 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.

The identified problem

19. Given the current interpretation challenges of the related party rules we support the Commission's Problem Definition Paper recognising the current related party transaction rules could be better specified to meet their intended purpose. We believe this means clearer definitions and greater certainty for interpretation.

Proportionate regulatory solutions

20. Vector agrees there is an opportunity to clarify the related party transaction rules and this should assist suppliers only applying intended interpretations of the rules.
21. We support the Commission focussing on the complexity of terminology and the understanding of the terminology. We agree there is the opportunity for improvement to harmonise the related party provisions across the IMs and IDs. We also agree there is also an opportunity to better align the purpose across the related party rules within the ID and IMs to ensure they have a consistent purpose.
22. Another area for improvement, not considered by the Commission's focus areas and solutions, is the "broadened definition of related party" beyond the GAAP rules to include internal unregulated divisions of a legal entity. PricewaterhouseCoopers as a qualified sector auditor provided feedback about interpretation concerns with this ambiguous widened definition. A clear definition about the term related party should mitigate the likelihood for selective interpretations.
23. To the extent possible, where the Commission can rely on established GAAP rules it should do so. This would avoid the interpretation concerns raised by Deloitte another sector auditor about complexity with rules driving interpretation ambiguity.
24. We also encourage the Commission to continue to have regard to materiality with the related party definitions. We see little advantage with applying stringent criteria for low value transactions.

Solutions not targeting identified problems

25. We encourage the Commission not to extend its solutions to matters not identified as problems. Such an approach will run counter to the Commission's approach for the IM review to avoid making wholesale changes that compromise the section 52R purpose of the IMs to provide certainty. Clearly articulated related party rules will ensure in-sourcing decisions are clear and transparent and not motivated by an opportunity to charge the regulated business above arm's length terms.
26. We see very little benefit from focussing on imperfect local markets for contracting services. The Commission's characterisation of imperfect markets does not show a problem with the related party transactions provisions. Instead it highlights a supply shortage for some regulated service inputs for some regional EDBs.
27. We also encourage the Commission not to create prescriptive rules around "tendering" arrangements. We can foresee such rules creating unnecessary additional transaction costs for suppliers. Vector for several years has operated a competitive external contracting service model for our field force and we have significant experience with service provider negotiations.
28. However, in our experience there are multiple considerations when selecting preferred partners which would be difficult to capture under prescriptive tendering or contestability rules. They include, *inter alia*, shared history, common business platforms (billing, support and customer interaction), shared philosophy (i.e. sustainability commitment), intellectual property, capability, confidence in delivery, willingness to accept risk and customer feedback.

Conclusion

29. We are encouraged by the thorough assessment the Commission has undertaken to understand the issues with related party transactions. A thorough understanding of the problem will ensure the Commission delivers solutions to address the identified issues with the current regime.
30. However, we do have reservations about the Commission over-complicating the issue of related party transactions. This may result in unnecessary solutions and accretive regulations with marginal consumer benefit. To this end, Vector recommends the Commission retains the philosophy it applied through the 2015-16 IM review of having a

starting premise the current IMs are fit for purpose and only seeking evidenced based changes to settled rules.

Yours sincerely
For and on behalf of Vector Ltd



Richard Sharp
Head of Regulatory