



# MAJOR ELECTRICITY USERS' GROUP

17 May 2017

Keston Ruxton  
Manager, IM Review  
Commerce Commission  
By email to [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz)

Dear Keston

## **Input Methodologies review - Related party transactions**

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission paper, "Input Methodologies (IM) review, Related party transactions, invitation to contribute to problem definition", 12 April 2017.<sup>1</sup>
2. MEUG members were briefly consulted in the preparation of this submission. Not all members support the proposed options to be considered in a long-list of solutions given insufficient time for MEUG to fully test those. This submission is not confidential. Some members may make separate submissions.
3. The paper makes a compelling argument that there is a high potential for harm to consumers from the current IM and information disclosure (ID) regime governing related party transactions. For example, if 5% of the related party transactions in 2016 had been at a higher price than had the service been procured on an arms-length basis then the harm to consumers would be approximately \$18 million per annum.<sup>2</sup> MEUG believes at least a 5% difference in the price of services is credible simply because of the high risk of misinterpretation of the provisions by Electricity Distribution Businesses (EDB) and auditors.
4. The Commission has asked for parties with evidence of excessive pricing of a service by an EDB's related party to the regulated portion of the EDB. MEUG suggests additional evidence would be "nice-to-have" rather than critical in deciding there is a high risk of harm to consumers. Therefore, the immediate focus should be on developing a long-list of options to consider and to pare that back to a short-list for final analysis and selection.

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<sup>1</sup> Refer document URL <http://www.comcom.govt.nz/dmsdocument/15357> at <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/related-party-transactions-provisions/>

<sup>2</sup> Total related party purchases of capex and opex by regulated electricity distribution services were \$360m in 2016, refer figure 3.2 of the paper.

5. MEUG welcomes the discussion in the paper on initial views on solutions to the potential, and highly likely problem, that the related party provisions are not leading to outcomes consistent with the purpose of Part 4 of the Act relative to an alternative set of provisions. However, we think the solutions are only a partial list. Solutions not considered in the paper include:

- a) EDB regulated line service entities publishing as soon as possible after the contract for provision of services from a related party that was not the subject of a contestable tender, the entire contract terms and conditions including price, and any other documentation or summary of any verbal agreement relevant to the provision of the service.

The paper focuses on the price of related party transactions but is silent on other terms and conditions. We suggest transparency of all terms and conditions is required because practices that allow exercise of excessive monopoly power or anti-competitive behaviour could be embedded in the contract or other documents and verbal agreements relevant to the arrangement and not apparent in the price.

The incremental cost of publishing this material would be small. We see no other costs that would accrue to the EDB. Implementing this requirement may flush out existing poor and legacy practices and incentivise EDB to establish explicit commercial terms and conditions.

Publishing all material contracts and other relevant documentation would lower the cost of interested parties scrutinising EDB behaviour. The requirement to publish such material would likely lift the importance to EDB, the Directors of EDB and auditors of complying with the provisions and tenor of the Act.

For transactions between a related party and an EDB regulated line service entity that were decided in a competitive tender, disclosure of contract terms and other relevant documentation need not be required provided a Director of the EDB and the auditor certified that in all material respects the terms and conditions offered for the related party and others were the same. Where provisions of the final agreement materially differed then those should be published.

- b) EDB with related party(s) that provide services to the regulated line entity should publish accounts for the related party(s) and those should be fully reconciled with the statutory accounts and regulated economic accounts of the EDB's regulated line service entity. Reconciliation between related party and regulated services will allow transparency of how value and risk is apportioned between those entities. The importance of this transparency is such that EDB Directors and auditors should be required to certify the reconciliation is accurate. With this policy in place, interested parties would have an accurate view of the related party and could assess at the enterprise level if outcomes were likely to achieve the outcomes of Part 4. That top down assessment of the inter-entity relationships is likely to be more effective over the longer term as the nature of services changes with emerging technologies and hence the appropriate risk and reward profile rather than relying on, for example, a set mark-up criteria of 17.2% for all related party transactions.<sup>3</sup>

The incremental cost to EDB with related party(s) to meet this requirement will be higher than the cost of publishing contracts and other arrangements suggested in a) above. MEUG notes reconciling economic regulatory accounts with statutory company accounts is not trivial; though as both are based on GAAP it is feasible and familiar to both auditors and Directors.

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<sup>3</sup> Mark-up of 17.2% is noted in CC paper, Table A2, p49.

In our view a prudent and proficient Board of an EDB would already have this information in conducting best practice governance. In that case the marginal cost of publishing such accounts and reconciliation would be small. EDB that do not have this information would incur a cost to become compliant; though the upside may be those Directors may decide changes in the structure of the EDB including related party(s) once apprised of this information.

MEUG recognises this possible solution will be controversial to EDB and the brief discussion above may have under-estimated the complexity of implementation and risks of possible unintended consequences. Nevertheless, we suggest that if the potential harm is greater than \$18m per annum and possibly increasing each year then all solutions, including this relatively heavy-handed disclosure requirement, should be considered at the first stage of a long-list of options.

6. The above may be part of a mix of solutions including those considered in the paper.
7. The possible policy solutions above are expressed in terms of the focus of the paper on "... transactions where parties related to the regulated supplier are supplying inputs to the supplier of a regulated service".<sup>4</sup> They may also be candidates for a long list of solutions for:
  - a) Services provided in the opposite direction, i.e." ... related party provisions cover sales from the regulated supplier to the related party."<sup>5</sup> We expect other parties will comment on the view in the same paragraph of the paper that "... these transactions are much less common than the ... inputs to the regulated supplier and are not a focus area of our review.
  - b) Improvements to cost allocation provisions and the key policy debate on the interface between regulated and un-regulated services.

The critical question of having transparency of how risk and value are apportioned between services that are regulated line services from other services that are not or can have dual utility to an end consumer may be solved by the options, in combination with other options, discussed in paragraph 5 above.

8. Finally, a suggestion that any changes to ID and IM in relation to related party transactions should also apply to Transpower. The paper excludes Transpower.<sup>6</sup> From a regulatory design point of view we cannot see any reason why in principle a generic solution for EDBs, GDBs and GTBs should also not apply to Transpower. Related party transactions may not currently be an issue with Transpower but that may not always be the case given the uncertainty of how emerging technologies may change the sector.

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<sup>4</sup> Ibid, paragraph 2.4

<sup>5</sup> Ibid, paragraph 2.8.

<sup>6</sup> Ibid, paragraph 1.10.

9. We look forward to viewing the submissions of other parties and engaging in the next consultation steps. MEUG has suggested the Commission consider a long-list of options first before focussing on a narrow choice as set out in the paper. If the Commission agrees that there is value in considering in parallel the problem(s) definition and a wide set or long-list of possible solutions, then it could be useful to add a new consultation-round to ensure all possible solutions are on the table at the same time the focus of the problem definition is weighed and finalised. That would then allow the current planned final consultation-round to consider the focussed problem definition and relevant short listed solutions.

Yours sincerely

A handwritten signature in black ink, appearing to read 'R. Matthes', with a long horizontal flourish extending to the right.

Ralph Matthes  
Executive Director