



Submission to the Commerce Commission

on

Input methodologies review: Related party transactions –
invitation to contribute to problem definition

17 May 2017

Introduction

1. Alpine Energy Limited welcomes the opportunity to submit on the Commerce Commission's *Input methodologies review: Related party transactions – invitation to contribute to problem definition* (the consultation paper).
2. We agree with the Commission that it is appropriate that there is an onus put on regulated suppliers to demonstrate that the underlying costs of services provided between related parties are efficient and consistent with what would have been paid had the parties not be in the relationship. That is we support the need to show transparently that we transact with our related party NETcon at arm's-length.¹
3. However, we disagree with the Commission as to what the problems are with the current framework in meeting that agreed obligation and thereby disagree as what the solutions are.
4. The Commission appears to be of the view that the current framework is not incentivising electricity distribution businesses (EDBs) to ensure that arm's-length transactions are occurring and thereby the costs to serve are inefficient. We have a very different view. We believe that the transactions between us and NETcon are at arm's-length and are therefore efficient. The problem as we see it is that we struggle to apply the options so we can transparently demonstrate that those transactions are arm's-length and so rely on director certification each year.

¹ Commerce Commission, *Input methodologies review: Related party transactions – invitation to contribute to problem definition*, 12 April 2017, paragraph 2.28, page 11.

5. Therefore, we view the problem to be one of understanding and application and not egregious behaviour as appears to be the Commission's definition of the problem.
6. Our difficulty arises as the result of the complexity and inconsistencies in the framework rather than a lack of incentives to demonstrate arm's-length transactions. Therefore we also disagree with the Commission on what the solution is.
7. The Commission's potential solutions include more compliance and disclosure requirements and the removal of last resort option—director certification. We see the solution as simplifying and aligning the requirements so as EDBs can more easily apply the requirements.
8. We are of the view that the Commission's proposed solution will add costs with little or no long-term benefit for consumers. Whereas our solution will reduce costs lower cost to serve providing a long-term benefit to consumers.
9. Many EDBs are consumer owned, through trusts, councils, or a mix of ownership. We are 40% owned by South Canterbury Lines Trust and 60% owned by local councils². For us lower costs to serve result in higher profits and those profits will be returned to consumers either directly through the trust as a dividend or indirectly through the councils via improved services and/or lower rates³. Thereby our solution meets the purpose of Part 4, whereas the Commission's solution does not.

The proposed solutions will cost consumers more

More compliance and disclosure requirements

10. The Commission proposes to introduce more compliance and disclosure requirements in two of the four focus areas⁴:
 - consideration of imperfect local markets in contracting services
 - compliance and disclosure requirements.
11. We are concerned that more compliance and disclosure requirements will result in additional costs to consumers for little or no benefit to those consumers.
12. Our current reporting obligations are extensive and detailed. Currently the reporting requirements take our regulatory team months to complete. The audit process is rigorous, intrusive, time consuming and costly.

² Our council ownership is Timaru District Council (47.5%), Waimate District Council (7.54%), and the MacKenzie District Council (4.96%).

³ In this regard we mean lower rates in real terms. As the need to increase rates to fund services can be deferred if the councils are able to fund their services via another means.

⁴ Supra n1, Table 5.1, page 44.

13. When our team is focused on regulatory reporting they are not focused on generating ideas that improve the way in which we provide our services to consumers through innovation (i.e., finding efficiencies). To increase compliance and disclosure requirements further would require either more resource or the resources that we have spending more time compiling the data and working with auditors to complete the reporting. Either way more compliance and disclosure requirements would result in an increase in costs.
14. We struggle to see how the increased reporting will result in the provision of more efficient services to consumers. While in theory an EDB could be using its related party relationships to inflate the costs of services, the Commission provides no evidence that EDBs are doing so. The Commission only provides insight into a theoretical basis on which EDBs could be doing so. Given the absence of evidence that there is an actual problem we are of the view that more compliance and disclosure requirements are solutions looking for a problem.
15. Accordingly, we submit that the solution is not to increase the compliance and reporting obligations as doing so will result in an increase in costs without any discernible short or long-term benefit to consumers. Additionally, increasing costs without long-term benefit to consumers does not meet the purpose of Part 4. Instead we recommend that the Commission reduce the complexity and address the inconsistencies between the input methodologies (IMs) and the information disclosure requirements (IDs).

Removal of director certification

16. We do not support the removal of director certification as an option. All other things being equal, with the complexities and inconsistencies appropriately addressed, EDBs will be able to use one or more of the other options in a year. Director certification would then become the exception as opposed to the option of choice.
17. However, there may be times when EDBs are not able to apply another option. For example, could Orion have applied any other option following the earthquakes of 2011? An option of last resort is necessary if we want to avoid the problems caused by having a regulatory framework with absolutes.
18. Should the Commission decide to keep the director certification option we would support the inclusion of additional disclosure requirements on the basis that those requirements are to provide additional information about why the other options could not be applied.
19. Overly onerous disclosure requirements associated with director certification could leave an EDB already facing exceptional circumstances facing further difficulties in complying with the regulatory framework and, as stated at paragraph 15 above, the costs could easily outweigh the long-term benefits to consumers.

Complexity and inconsistencies

20. At paragraphs 2.18 to 2.22 of the consultation paper the Commission identifies the inconsistencies between the IMs and the IDs. The Commission does not however in the consultation paper appear to propose how it will address these inconsistencies.
21. Nowhere in the consultation paper does the Commission discuss the complexities of the regime or the difficulties that EDBs have experienced in applying the options. From that omission we can only conclude that the Commission does not view the complexities to be an issue, which is surprising given that the matter has been raised a number of times with the Commission in submissions and less formally in discussions.
22. Accordingly, we ask the Commission to take this opportunity to consider both the issues of complexity and inconsistencies in identifying the problem definition and solution as it proceeds to the next stage, which we assume is the release of a draft decisions paper.

Surprised by Commission's view

23. We are surprised by the Commission's view as there appears to be little evidence that EDBs are behaving in such a way that:
 - related party relationships are resulting in inefficient costs; or
 - are passing inefficient costs on to consumers; or
 - failing to pass on gains from realised efficiencies onto consumers.
24. We suggest that EDBs are struggling to apply the rules due to the complexities and inconsistencies in the framework as opposed to actively engaging in egregious behaviour.
25. We were one of the EDBs that assisted the Commission with its preliminary consideration of the problem definition. At no time did we believe that any of the information that we provided indicated that our related party relationship was resulting in inefficient costs being passed onto our consumers. Nor were we aware that we had implied, inferred or evidenced that we were failing to pass on gains from realised efficiencies onto consumers. In fact we were forthcoming and circumspect in our view that we were struggling to apply the options and felt that that was where the problem lay.
26. We found the experience very useful and discovered that we had misunderstood one of the options, which we thought we could not apply but could. That discovery was very helpful and we are working to change our processes so as we can use that option instead of director certification at future disclosure years.

27. We appreciate that the Commission needs to take a generalist view point when discussing the need for the regulation as there are underlining principles associated with monopoly behaviours and the, consequently, the regulation of those monopolies. However, in its consultation paper the Commission appears to be inferring that EDBs have been actively behaving in a manner that requires further rules be put into place without providing any evidence that any such behaviour has been or is occurring⁵.
28. The danger in making such assertions is that EDBs that are having problems with applying the rules are less likely to seek clarification or assistance from the Commission if in doing so they are opening themselves up to action for perceived as opposed to overt behaviour.
29. Accordingly, we appeal to the Commission to consider adopting our problem definition—being that EDBs are struggling to demonstrate arm’s-length transactions because the options as currently written are overly complex, inconsistent and difficult to apply. Rather than continuing with its current problem definition that EDBs are using related party relationships to intentionally inflate costs to serve.

Closing Comments

30. We hope that our submission is helpful to the Commission. We are happy to discuss our views further with the Commission should it find it useful.
31. The main contact for this submission is:
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⁵ Supra n1, paragraphs 2.7, 2.29, 2.31, and 2.32, at pages 6 and 11 respectively.