

17 May 2017

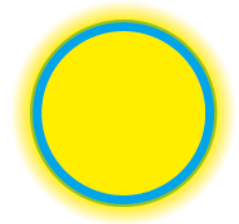
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Dear Keston

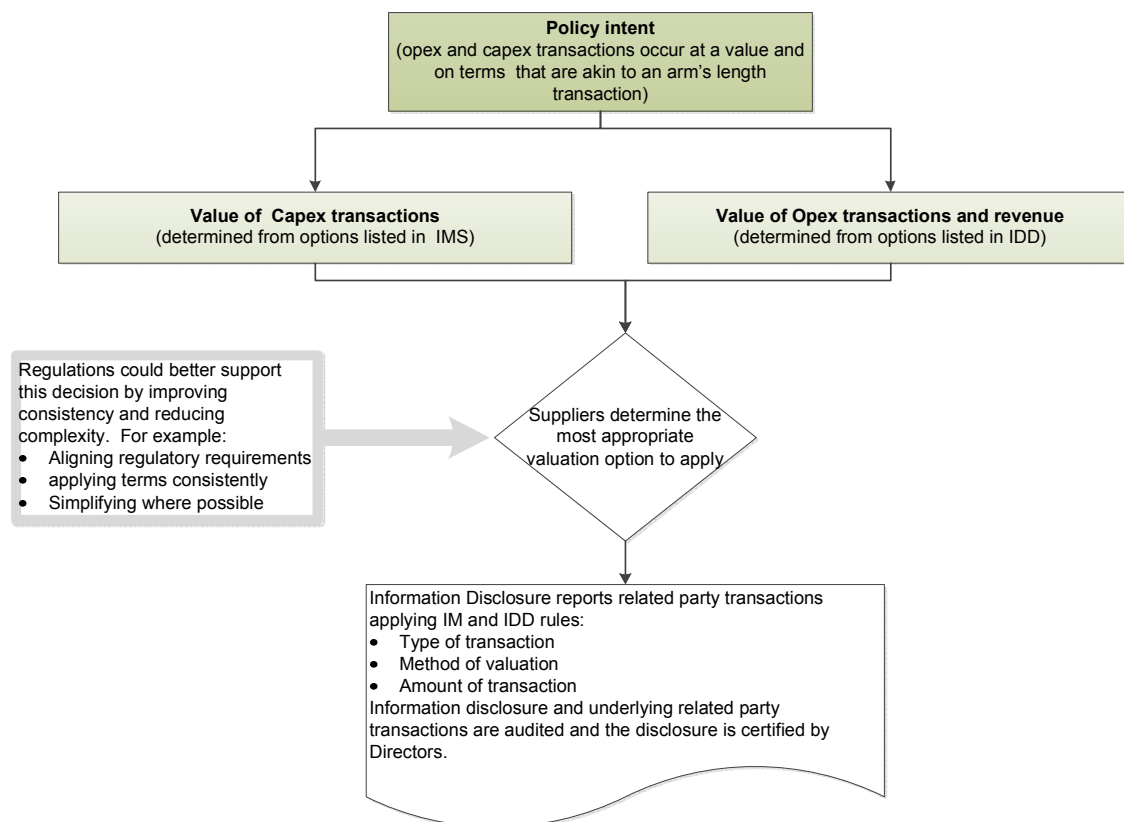
Related party transactions: invitation to contribute to problem definition.

1. Powerco welcomes the opportunity to contribute to the Commerce Commission's (the Commission) input methodology review for related party transactions. This is our submission on the Commission's consultation paper *Input methodologies review: Related party transactions – invitation to contribute to problem definition* dated 12 April 2017 (the consultation paper).
2. Powerco reports its related party transactions annually as part of the Commission's information disclosure regime.
3. We have reviewed the Electricity Networks Association (the ENA) submission in response to the Commission's problem definition paper. We support the points made by the ENA in its submission.

Summary

4. We support the Commission's review of the related parties' regime and the focus on ensuring the policy intent is still being met.
5. We agree that broad problem with the current regime is the underlying design and implementation of the related party transaction rules. It is difficult to establish a regime that will meet all circumstances. The current rules of the regime, both in the Input Methodologies (IMs) and the Information Disclosure Determinations (IDD) can be confusing and complicated to apply. This may result in regulated suppliers applying the rules incorrectly or inconsistently.
6. Aligning the rules between IDD and IMs, simplifying them, and applying terms consistently within the regulations will alleviate the issues the Commission has identified. The valuation of transactions should then be consistent across the industry and suppliers (and their auditors) will have the guidance they need. Further, consistency and correct application of the related party regime requirements will provide greater transparency of how the transactions are valued. Our view is
7. Our view is summarised in Figure 1 below.

Figure 1: Improving the current regime to meet the policy intent



Policy intent remains appropriate

The policy intent of the related party regime is to ensure¹:

1. Related party transactions are treated and expressed in a way that is akin to transactions made at arm's-length values and terms; and
2. Where a regulated supplier transacts with a related party, the value of the transaction should therefore be based on a demonstrated objective and independent measure, which may differ from the actual purchase price.

This policy intent is reflected in the Input Methodologies applying to the value of capital expenditure (capex) transactions. The Information Disclosure Determination (IDD) also requires the value of related party transactions to be based on, or linked to, objective verifiable information. The IDD provides guidance on valuing related party transactions within operational expenditure (opex).

These regulatory mechanisms support the policy intent by providing a menu of options for valuation. The menu approach recognises that suppliers have varying company ownership structures and transactions for a variety of goods and services occur between the supplier and its related parties.

In meeting this policy intent, the Commission further recognise that suppliers may operate in imperfect markets. This is true for companies such as Powerco where we have a large network that covers large centres through to very small country towns. In the smaller and more remote areas of our network, for example, we may not be able to use a comparable market value to determine a related party opex transactions value. It is therefore useful to have the menu of options provided in

¹ Commerce Commission Input methodologies review: related party transactions – invitation to contribute to problem definition, 12 April 2017, pg18

the IMs and IDD to assist suppliers valuing the related party transactions appropriately and in a cost effective manner.

Problem definition should focus on improving the design of the rules

The Commission indicates in the consultation paper that the policy intent of the regime remains fit for purpose. However, they have found that the broad problem with the regime is that the practical application of the related party provisions is not well aligned with the policy intent.

We agree with the Commission's findings². The broad problems of the regime are:

1. Aspects of the design and implementation of the related party rules
2. Aspects of the way some regulated suppliers have applied the rules.

The second issue simply follows from the first.

Aspects of the current design are difficult to interpret and therefore implement. The difficulties we have experienced appear to be common to suppliers as evidenced in the Commission's findings. We have found the complexity of the rules and inconsistency between IMs and IDD particularly troublesome. We welcome a review of these rules.

Aligning the regulatory requirements in the IMs and IDD will assist in consistent application by regulated suppliers. Further, the use of the term *directly attributable costs* should be clarified. This term is used in the IDD and IMs with reference to cost allocation. The use of this term in both areas adds to confusion as it links the two concepts. The application of this term for separate purposes causes difficulty with interpreting how the rules should be applied.

Consistent rules will support transparency objectives

If the rules are aligned, potentially simplified and common terms are explained then regulated suppliers can apply the rules on a consistent basis. This will help resolve the Commission's concern that the valuation method is not transparent. These variations of interpretation should not misconstrued as a lack of transparency.

We support a robust assessment of the rules around disclosure to ensure they respect commercial sensitivity. We support the ENA submission that a potential test for public disclosure is whether similar information is transparently available in the market.

Director certification is a robust valuation option

The Commission have suggested that the option of Directors Certification is not a necessary valuation option. We disagree with this view and support the ENA recommendation. This option should be retained and used where other options are impractical, excessively costly to obtain, unreliable or provide values that are manifestly unreasonable.

The Director's certification option requires regulated suppliers prove to their Board that they can be satisfied the costs and revenues recorded for related party transactions reasonably reflect the price or prices that would have been paid or received had these transactions been at arm's-length. Directors must then certify to this extent in the information disclosure. Our directors take any certification very seriously and require a high burden of proof. Our auditors also review our related party transactions and take a principled approach as well as apply GAAP and transfer pricing

²

requirements. While the definition for related parties is broader under the IMs than under GAAP, the same principled approach is appropriately applied.

Workshops and examples are helpful

The second problem identified in the regime by the Commission is how regulated suppliers have applied the rules. We believe this is simply due to mis-interpretation of a complex set of rules.

We have appreciated the Commissions guidance provided through workshops and worked examples in the past. We recommend the Commission provide some worked examples to assist suppliers in this area or perhaps consider a workshop if warranted at the end of the review process.

Contact for submission

Thank you for the opportunity to provide comments on this consultation. If you wish to discuss any of the points made, or clarify any matters, in the first instance please contact Lynette Taylor tel. (06)968 6235, email lyn.taylor@powerco.co.nz.

Yours sincerely

A handwritten signature in black ink, appearing to read 'R Fletcher', written in a cursive style.

Richard Fletcher
General Manager Regulation and Corporate Affairs