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Input methodologies review

Related party transactions – Invitation to contribute to problem definition

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Associated documents

Publication date	Reference	Title
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14 September 2016	978-1-869455-36-1	Input methodologies review: Process update paper
14 September 2016	Notice of intention	Amended notice of intention: Input methodologies review
20 December 2016	978-1-869455-44-6	Input methodologies review decisions: Introduction and process paper
20 December 2016	978-1-869455-53-8	Input methodologies review decisions: Framework for the IM review
20 December 2016	978-1-869455-51-4	Input methodologies review decisions: Report on the IM review
1 October 2012	978-7-869452-09-4	Information Disclosure for Electricity Distribution Businesses and Gas Pipeline Businesses: Final Reasons Paper
16 January 2012	978-1-869451-87-5	Information Disclosure Requirements for Electricity Distribution Businesses and Gas Pipeline Businesses Draft Reasons Paper
22 December 2010	978-1-869451-32-5	Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper

Commerce Commission

Wellington, New Zealand

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Chapter 1 Introduction

Purpose of this paper

- 1.1 This paper provides:
- 1.1.1 an outline of what related party transactions are and why these are important to consumers; an outline of the policy intent of the related party transactions provisions and our assessment of the continued relevance of the policy (Chapter 2);
 - 1.1.2 an overview of our initial findings based on what we currently know about the operation of the related party transactions regime (Chapter 3);
 - 1.1.3 an explanation of our emerging view on the problems with the current related party transactions input methodologies (**IMs**) and information disclosure (**ID**) provisions (Chapter 4); and
 - 1.1.4 our initial views on potential solutions (Chapter 5).

Background

How this paper fits into the input methodologies review

- 1.2 In September 2016, we decided to progress the review of the related party transactions provisions on a longer timeframe than the rest of the IM review.¹ This was to allow more time to assess whether the issues identified in our June 2016 related party transactions topic paper amount to a broader problem with the related party transactions regime.²

¹ Commerce Commission “Input methodologies review: Process update paper” (14 September 2016); Commerce Commission “Amended notice of intention: Input methodologies review” (14 September 2016).

² Commerce Commission “Input methodologies review draft decisions: Topic paper 7 – related party transactions” (16 June 2016).

- 1.3 On 20 December 2016 we published our final decisions on all areas of the IM review except for three areas where we have not yet reached decisions. One of those areas is the related party transactions provisions, which is the focus of this paper.³
- 1.4 Having now undertaken further analysis of the related party transactions regime, this paper presents our view on the problem definition for the related party transactions provisions. It also sets out our proposed next steps for reaching decisions on the solutions to such problems in Chapter 5.
- 1.5 Our review of the related party transactions regime remains part of the IM review that we commenced in June 2015.⁴ As previously indicated, we consider it useful that our review of the related party transactions regime also considers whether changes to the ID requirements might be required.⁵
- 1.6 As this work remains part of the IM review, we will continue to apply our IM review framework for decision-making.⁶
- 1.7 Whilst we refer to the related party transactions provisions as a ‘regime’, if we conclude that amendments are required to any of the features of this regime, we would amend individual IMs (for example, value of commission assets) or ID requirements.⁷

³ Our final IM review decisions can be found in Commerce Commission “Input methodologies review decisions: Summary paper” (20 December 2016). The other two areas where we have not yet reached decisions on the IM review are the Transpower Incremental Rolling Incentive Scheme IM and the IMs relating to CPP information requirements for gas. See Commerce Commission “Input methodologies review decisions: Introduction and process paper” (20 December 2016).

⁴ Commerce Commission “Notice of intention: Input methodologies review” (10 June 2015); subsequently amended by Commerce Commission “Amended notice of intention: Input methodologies review” (14 September 2016).

⁵ We note any changes to the ID requirements would be consulted on and made under s 52Q of the Act, rather than under s 52Y. Our topic paper indicated that we would review our related party provisions across ID and the IMs in parallel. See Commerce Commission “Input methodologies review draft decisions: Topic paper 7 – related party transactions” (16 June 2016).

⁶ Commerce Commission “Input methodologies review decisions: Framework for the IM review” (20 December 2016).

⁷ See attachment A for more detail on the IM provisions which could be affected.

Structure of this paper

- 1.8 Following this introductory chapter:
- 1.8.1 an outline of the policy intent of the related party transactions provisions and our assessment of the continued relevance of the policy is provided in Chapter 2;
 - 1.8.2 an overview of our initial findings from our sample discussions in the electricity distribution businesses (**EDB**) sector is outlined in Chapter 3;
 - 1.8.3 our views on the problem are provided in Chapter 4;
 - 1.8.4 our initial views on potential solutions are outlined in Chapter 5;
 - 1.8.5 a full outline of our related party transactions provisions is provided in Attachment A; and
 - 1.8.6 an overview of the difference between the respective functions of cost allocation and the related party transaction valuation methodology is provided in Attachment B.

Who this paper may be relevant to

- 1.9 The related party transactions provisions discussed in this paper apply to EDBs, gas distribution businesses (**GDBs**) and gas transmission businesses (**GTBs**).
- 1.10 This paper may also be of interest to:
- 1.10.1 entities involved in (or planning to be involved in) related party transactions with EDBs, GDBs or GTBs;
 - 1.10.2 entities other than related parties that are involved in (or planning to be involved in) transactions to provide services or assets to EDBs, GDBs or GTBs;
 - 1.10.3 other gas and electricity firms, such as generator-retailers; and
 - 1.10.4 consumers of electricity lines services and gas pipeline services.

Invitation to make submissions

- 1.11 We invite submissions on this paper by **5pm, Wednesday 10 May 2017**.
- 1.12 In preparing this paper we had discussions with a sample of EDBs and sector auditors to better understand, amongst other things, how they are applying the related party transactions provisions (see Chapter 3).

1.13 If other EDBs, GDBs, GTBs or other interested entities consider they have examples of how they apply the rules that might help us to come to our draft decision, please contact us at the address below and we will consider if further discussions would be of value. Note that this would not be a substitute for submissions on this paper.

1.14 Please address submissions to:

Keston Ruxton
Manager, Regulation Development
Regulation Branch
regulation.branch@comcom.govt.nz

Proposed next steps

1.15 We plan to publish our draft decision, including any draft amendments to the IMs and ID requirements for consultation by the end of August 2017.

1.16 We plan to publish our final decision, including any final amendments to the IMs and ID requirements by December 2017.

1.17 Any amendments made to the EDB IMs Determination following this process would have effect for the EDB 2020 default price-quality path (**DPP**) reset (ie, the rules would apply to the DPP commencing on 1 April 2020). Amendments to the GDB and GTB IMs Determinations would have effect for the GDB and GTB 2022 DPP resets (ie, the rules would apply to the DPPs commencing on 1 October 2022).

1.18 Any amendments would take effect for any customised price-quality path (**CPP**) proposal submitted to us from the date the amendments are made in December 2017. Any amendments to the EDB ID Determination would have effect for disclosure year 2019 (ie, disclosure year commencing 1 April 2018). The objective would be to ensure that at least one year of updated disclosures is available to us for reference in determining the 2020 DPP reset.

1.19 Any amendments to the GDB and GTB ID Determinations would have effect from at least disclosure year 2019 (ie, disclosure year commencing 1 June 2018 or 1 October 2018 depending on the entities involved).⁸

⁸ For ID there may be options for earlier implementation of some amendments to ensure that updated ID requirements are reflected in all disclosure years impacted by the Gas 2017 DPP resets.

Chapter 2 Related party transactions policy intent

Purpose of this chapter

- 2.1 This chapter provides:
- 2.1.1 an outline of the focus of this review further explained in Chapter 4;
 - 2.1.2 some essential background about the related party transactions regime;
 - 2.1.3 an explanation of how we have applied the IM review framework in reviewing the related party transactions provisions; and
 - 2.1.4 an explanation of the policy intent of the related party transaction provisions and our view that this policy intent remains relevant.

The focus of this review

- 2.2 Related party transactions occur when a regulated business transacts with an entity which is related to it by a common shareholding or other common control. The assumption is that those transactions may not be on arm's-length terms and that input costs of the regulated business may not reflect costs that would otherwise apply in the absence of such a relationship.⁹
- 2.3 The total volume and value of related party transactions are proportionately large for regulated services (ie, electricity lines services and gas pipeline services) and appear to be growing.¹⁰ We are therefore concerned at the potential for consumer harm.
- 2.4 As part of this review, we are interested in transactions where parties related to the regulated supplier are supplying inputs to the supplier of a regulated service.
- 2.5 We are therefore concerned that suppliers of the regulated service have the ability to use an unregulated related party to increase their combined profits by overcharging for inputs to the regulated service that are supplied by the related party.

⁹ In referring to 'input costs', we are referring to capital expenditure and, or, operating expenditure costs to the regulated supplier.

¹⁰ The scale of related party transactions across EDB opex and capex can be seen in Figures 3.2 to 3.4 in chapter 3.

- 2.6 The regulated price that we set for regulated services is expected to be less than the maximised monopoly price the regulated supplier might otherwise charge. In order to maximise profits, there could be an incentive to use a related unregulated service provider to supply inputs at increased prices and indirectly move the regulated price closer to the monopoly price.
- 2.7 We are also concerned that a supplier of a regulated service may be incentivised to use a related party for an input to the related service even though it may not be the most efficient provider of the input.
- 2.8 Although our related party provisions cover sales from the regulated supplier to the related party, we consider these transactions are much less common than the operating expenditure (**opex**) and capital expenditure (**capex**) inputs to the regulated supplier and are not a focus area of our review. However, these sales provisions will be reviewed as part of our draft and final decisions.
- 2.9 We first put these provisions in place in 2010 (IMs) and 2012 (ID). We are now reviewing these as part of our IM review process. The focus of our review is explained further in Chapter 4.

Background

Related party defined

- 2.10 Related parties are generally understood for business purposes under the generally accepted accounting principles (**GAAP**) definition as follows:

A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').¹¹

- 2.11 As we regulate services rather than legal entities, the definition of a related party has been broadened in the IMs to mean:¹²

Related party means -

(a) A person that, in accordance with GAAP, is related to the EDB in question; or

(b) Any part of the EDB in question that does not supply the regulated services.¹³

¹¹ As defined in International Accounting Standards 24 Related Party Disclosures.

¹² As defined in Commerce Commission "Electricity Distribution Services Input Methodologies Determination 2012" Consolidated February 2017, clause 1142.

¹³ Regulated services refer to electricity distribution services, gas distribution services and gas transmission services as outlined in their respective IM determinations.

- 2.12 The result of this broadened definition is that it includes not only related separate legal entities but also internal unregulated divisions of the legal entity that provide the regulated service.

Arm's-length transactions

- 2.13 An arm's-length transaction assumes two parties are acting independently in their own self-interest as if they were connected or related only by the transaction or dealing in question.
- 2.14 When looking at a related party transaction, we consider whether the transaction could be considered to be equivalent to an arm's-length transaction. The often unobservable arm's-length counterfactual is the price that would be charged by competing unrelated providers of the input (opex or capex from the related party to the supplier of the regulated service).
- 2.15 The definition of arm's-length that applies in the IMs refers to that contained in clause 1(2) of Schedule 3 of the Electricity Industry Act 2010:¹⁴

"...arm's length includes having relationships, dealings, and transactions that -

(a) do not include elements that parties in their respective positions would usually omit;
and

(b) do not omit elements that parties in their respective positions would usually include,-

If the parties were-

(c) connected or related only by the transaction or dealing in question; and

(d) acting independently; and

(e) each acting in its own best interests.

¹⁴ The only difference being that in the IMs, we replace the word "elements" with the word "terms" in our definition of an arm's-length transaction. Commerce Commission "Electricity Distribution Services Input Methodologies Determination 2012" Consolidated February 2017. This is not intended to alter the meaning.

Our related party provisions

- 2.16 We regulate related party transactions through both our IM and our ID rules:¹⁵
- 2.16.1 Part 2 of each of the sector IM determinations applies related party transaction rules to capex included in the value of commissioned assets that enters the regulatory asset base (**RAB**) for the purposes of both ID and price-quality paths;¹⁶ and
 - 2.16.2 The ID determinations have valuation rules that cover the cost of commissioned assets and electrical contracting services provided to or from a regulated service in transactions between the regulated service and related parties, and a requirement to provide a report on related party transactions (ie, in respect of both capex and opex).¹⁷
- 2.17 Although we value the cost of operating expenditure under the ID provisions, we also take these values into account in forming our conclusions on the opex allowances we use when setting a price-quality path.

¹⁵ A full outline of our related party transactions provisions is provided in Attachment A.

¹⁶ Commerce Commission “Electricity Distribution Services Input Methodologies Determination” (2012), clause 2.2.11(1)(g); Commerce Commission “Gas Distribution Services Input Methodologies Determination” (2012), clause 2.2.11(1)(g); Commerce Commission “Gas Transmission Services Input Methodologies Determination” (2012), clause 2.2.11(1)(g). These provisions are set out in accordance with s 52T(a)(ii) of the Act.

¹⁷ Commerce Commission “Electricity Distribution Information Disclosure Determination” (2012), clauses 2.3.6 and 2.3.7, and Schedule 5b; Commerce Commission “Gas Distribution Information Disclosure Determination” (2012), clauses 2.3.6 and 2.3.7, and Schedule 5b; Commerce Commission “Gas Transmission Information Disclosure Determination” (2012), clauses 2.3.7 and 2.3.8, and Schedule 5b. These provisions are set out in accordance with s 53C(2)(e) and (k) and s 53D of the Commerce Act.

- 2.18 The common transactions covered by the related party provisions:
- 2.18.1 IMs¹⁸
 - 2.18.1.1 the valuation of assets acquired from a related party.
 - 2.18.2 ID¹⁹
 - 2.18.2.1 the valuation of services (all opex) acquired from a related party; and
 - 2.18.2.2 the valuation of sales supplied to a related party.
- 2.19 Our current related party provisions provide valuation methodologies that are intended to ensure transactions between a related party and a supplier of regulated services are akin to arm's length terms and values.
- 2.20 These provisions consider the valuation and disclosure of inputs from a related party to the supplier of the regulated service (capex and opex) or sales to a related party by the supplier of the regulated service.
- 2.21 These provisions sit across the IMs and ID, with opex inputs and sales to a related party covered in ID and asset valuation in the IMs (and imputed into ID). This division of rules occurs because the IMs set out the rules for the valuation of assets and capex. Our rules for the valuation of opex are instead set out in ID, which is consistent with the IM review framework.²⁰
- 2.22 These provisions are described in more detail in Attachment A.

¹⁸ The related party capex transaction valuation methodology for EDBs is provided in Commerce Commission "Electricity Distribution Services Input Methodologies Determination" (2012), clause 2.2.11(5)(a)-(i). As also applied for ID purposes in Commerce Commission "Electricity Distribution Information Disclosure Determination" (2012), clauses 2.3.6.

¹⁹ The related party opex and sales valuation methodology for EDBs is provided in Commerce Commission "Electricity Distribution Information Disclosure Determination" (2012), clauses 2.3.6 and 2.3.7.

²⁰ We cannot create an IM on a matter not covered by an existing IM under s 52Y or s 52X of the Act. See Commerce Commission "Input methodologies review draft decisions: Framework for the IM review" (16 June 2016), para 51.

Why we regulate related party transactions

2.23 The purpose of Part 4 of the Commerce Act (**the Act**) is outlined as:²¹

The purpose of this Part is to promote the long-term benefit of consumers in markets by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—

(a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and

(b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and

(c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and

(d) are limited in their ability to extract excessive profits.

2.24 When suppliers are selling their goods or services in competitive markets, the price they charge reflects the interplay between demand and supply from a range of other parties. In this context, typically, a consumer does not care what costs the supplier incurs and why, nor do they care whether the supplier has used related party relationships to produce its service.

2.25 This is because the consumer has choices over what to buy and from whom, and can switch products or suppliers if they find a better offer. One supplier attempting to pass on costs specific to it (not borne to the same extent by other suppliers) can expect to lose market share, and potentially profits, as consumers may prefer other suppliers' offers.

2.26 In contrast, a supplier of a regulated service has market power and in the absence of regulation, would charge a price that reflects that market power. The regulatory price for their services is determined largely by the costs they incur. For example, as a starting point under our price-quality regulation, we assume the costs that regulated suppliers incur reflect efficient costs, and we use estimates of actual and forecast costs to inform starting prices.

2.27 Exempt suppliers too may use their actual or budgeted costs to determine prices for their services. In the regulated context, we and consumers therefore care about whether the underlying costs incurred in setting prices are efficient, and in particular whether the cost paid for a service from a related party is efficient, because it may directly impact on the price that consumers ultimately pay.

²¹ Commerce Act 1986, s 52A.

- 2.28 We do not seek to prevent regulated suppliers from using related parties to provide services as they can be efficient, securing economies of scale and scope. However, there is an onus on the regulated supplier to be able to demonstrate that the cost of the underlying service is efficient and consistent with the input price that it would have paid in an arm's-length transaction.
- 2.29 In developing our related party provisions across our regulatory rules, we assume the related parties transacting with the supplier of the regulated service are not independent. Therefore, the terms and conditions at which an asset or service is transacted may not be consistent with an arm's-length transaction. This is a situation we wish to avoid as it could affect the achievement of the Part 4 purpose as discussed below.
- 2.30 We currently provide a number of valuation disclosure options across our IM and ID determinations. These attempt to value transactions akin to arm's-length terms. Such mechanisms include directly attributable costs, director certification and a mark-up of 17.2% on directly attributable costs in opex to account for indirect costs. These valuation methodologies are outlined further in Attachment A.
- 2.31 One example of how the terms and conditions could advantage the related party to the detriment of the consumer of the regulated service, is where the price for an asset or service charged to the regulated supplier is higher than would be paid in an arm's-length transaction (ie, between independent parties).
- 2.32 A higher price could enhance the profit of the related party (typically an unregulated entity) to the detriment of the consumers of the regulated supplier. This is because the absence of an arm's-length relationship can lead to a transfer of value that would not otherwise be expected to occur if the parties were not related.
- 2.33 As we explained in our 2010 reasons paper:²²

Where a supplier of a regulated service purchases an asset from a related party—or sells an asset to a related party—the value at which the asset is transferred is potentially open to manipulation. Our presumption is that transactions with a related party are not arm's-length transactions. Without the discipline of an arms' length negotiation the price paid may be greater (or less) than the asset's market value.

²² Commerce Commission "Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" December 2010, E8.8.

- 2.34 The 2010 decision specifically looked at the purchase of an asset (capex). The provisions relating to this were set out in the IMs. However, similar considerations are applied to the provision and receiving of services.²³ Rules for these services are set out in ID which requires regulated suppliers to disclose related party transactions using one of several valuation options. These options are intended to value related party transactions consistent with arm's-length transactions.²⁴

Outcomes and risks of related party transactions with respect to the Part 4 purpose

- 2.35 We consider that transactions between related parties have the potential to impact the achievement of the objectives of Part 4 purpose.²⁵
- 2.36 Table 2.1 sets out the relevant regulatory objectives under Part 4 and considers the outcomes and risks that related party transactions can have on the achievement of these objectives.²⁶

²³ That is opex from the related party to the regulated service and sales from the regulated service to the related party.

²⁴ Commerce Commission "Information Disclosure for Electricity Distribution Businesses and Gas Pipeline Businesses: Final Reasons Paper" (1 October 2012), para 3.37.2.

²⁵ As set out in s 52(a)(1(a)-(d) of the Act.

²⁶ We also consider the s 53A ID purpose in our review of the related party provisions further on in this chapter.

Table 2.1 Risks to regulatory objectives posed by related party transactions

Regulatory objective	Intended outcome	Potential risk of related party transactions
Efficiency ²⁷	Suppliers of regulated services should have incentives to improve efficiency in the supply of the regulated goods or services and share the benefits of efficiency gains with consumers through lower prices.	<p>Close business relationships (including related party relationships) may generate economies of scale and scope that could benefit consumers. However, the presence of related party transactions, coupled with the lack of information on what an arms-length price would have been, can:</p> <ul style="list-style-type: none"> • make it hard to determine if efficiencies (or inefficiencies) are being created; and • whether any efficiencies are being shared with consumers of the regulated service or if these are being enjoyed by the related party. <p>Our related party transactions regime seeks to ensure such efficiencies are shared with consumers.</p>
Profits	Suppliers of regulated services should expect profits are just sufficient to reward investment, efficiency and innovation. Superior performers are more likely to be rewarded by receiving returns greater than a ‘normal profit’ (or ‘normal return’—i.e. their risk-adjusted cost of capital), at least for the short to medium term, until competitors catch up. Over the lifetime of its assets, a typically efficient supplier would not invest unless it expected, in advance, to earn at least a normal return.	Due to the close business relationship between related parties, the value of profit transferred is potentially open to manipulation. Such manipulation could lead to excess profits being earned by the related party. This could adversely affect the consumer of the regulated service through higher prices. This is a key consideration in our review.
Price	The price paid by consumers should be based on efficient input costs. In workably competitive markets, suppliers have incentives to constrain price.	The presence of related party transactions may adversely affect the ability to constrain prices to the benefit of consumers, as there is an ability to use an unregulated related party to increase overall profits, but not to the benefit of the consumer. This is a key consideration in our review.

²⁷ When referring to efficiency of related party transactions, we are referring to efficiencies in providing services at a quality that reflects consumer demands and the sharing with consumers of the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices. See s 52A of the Act.

Quality	Suppliers of regulated services should have incentives to improve efficiency and provide services at a quality that reflects consumer demands.	The presence of related party transactions may adversely affect quality of service provided to consumers of the regulated service if the relationship means quality is traded off in favour of other interests of the party supplying the service. This issue is not a primary driver of the current related party provisions across the IM and ID determinations.
Investment	Suppliers of regulated services should have incentives to undertake investments at an efficient level at the optimal time (to the extent these levels and time can be ascertained).	The presence of a related party relationship and extensive related party transactions could affect the level and timing of investment. For example, if weight is placed on the interests of the related party supplying the service, more investment may be undertaken, and at greater cost, than if the relationship and all transactions were on an arm's-length basis.
Innovation	Suppliers of regulated services should have incentives to promote the discovery and use of new information, leading to the development of new goods and/or services, and more efficient production techniques.	Given related parties are not independent and have an ongoing close operating nature, there can be reduced pressure from the commercial relationship to be innovative.

Relationship between cost allocation and the related party transactions provisions

- 2.37 The cost allocation rules split shared costs between regulated and unregulated activities. For example, common operating costs (eg, expenses for the head office) and commonly used assets (eg, poles which carry both electricity and optical fibre) have their costs shared between regulated and unregulated services.²⁸
- 2.38 Sharing of services can produce cost efficiencies. A purpose of cost allocation is to ensure these efficiencies are shared with consumers.
- 2.39 However, the cost allocation IM does not address:
- 2.39.1 the value of revenues derived from a related party; or
- 2.39.2 the value placed on services supplied by a related party.
- 2.40 These are dealt with in the related party transactions provisions to ensure such transactions are on terms that are akin to arm's-length. An overview of the difference between the respective functions of cost allocation and the related party transactions valuation methodology is provided in Attachment B.
- 2.41 For example, when considering an integrated unregulated business unit of a regulated supplier (ie, an unregulated branch or division), the related party rules assess the valuation of goods and services provided by unregulated business units or related separate entities. Cost allocation then looks at the splitting of shared costs between unregulated and regulated activities.²⁹

Related party transactions provisions do not deal with all issues of market power

- 2.42 Our related party transactions rules address amounts paid by a regulated supplier to related parties that eventually get passed on as input costs when setting the prices to customers of the regulated service (and also the adequacy of any amounts charged to related parties when the regulated service is providing goods or services to them).
- 2.43 However, the rules are not intended to address situations where the regulated supplier requires the customer of the regulated service to pay an amount directly to a third party, eg, in setting the amount of a capital contribution for an electricity connection.

²⁸ Cost allocation rules are found in the IM determinations in Part 2, subpart 1.

²⁹ This is outlined further in Attachment B.

- 2.44 It is feasible that regulated suppliers might set policies which constrain who may be permitted to undertake work on their network and who may directly charge consumers for that work. By constraining who can undertake such work, this could restrict competition in the market for contracting services. If the related party exploits this, it could lead to an individual consumer effectively paying excessive prices for their regulated services.
- 2.45 This is because the related party transactions provisions deal with the total cost of the goods or services, but not with individual customer contributions made to pay for those goods or service.
- 2.46 However, s 36 of the Act prohibits a person with substantial market power in a market from taking advantage of that power for the purpose of preventing, restricting or deterring competition, as follows:³⁰
- A person that has a substantial degree of power in a market must not take advantage of that power for the purpose of—
- (a) restricting the entry of a person into that or any other market; or
 - (b) preventing or deterring a person from engaging in competitive conduct in that or any other market; or
 - (c) eliminating a person from that or any other market.
- 2.47 The IMs and ID requirements are not designed to detect such conduct where a regulated supplier takes advantage of market power. This could be by, for example, preventing competitors of its related party from competing to supply it with services. This is instead brought to our attention via a complaint under the Act.

Reviewing the related party transactions provisions

- 2.48 Consistent with the IM review framework, in reviewing the related party transactions provisions, we have considered whether the policy intent is still relevant, and whether the way the provisions have been implemented could be more effective in achieving that policy intent, or achieve it in a way that better promotes s 52R or reduces complexity and compliance costs.³¹

³⁰ As outlined in s 36 of the Act.

³¹ This is set out in more detail in: Commerce Commission "Input methodologies review decisions: Framework for the IM review" (20 December 2016).

- 2.49 In deciding whether to make changes to the provisions as a result of this review, we are guided by the IM review framework. Specifically, we will only propose changing the related party transactions provisions across the IMs and ID where this appears likely to:
- 2.49.1 promote the Part 4 purpose in s 52A more effectively;
 - 2.49.2 promote the IM purpose in s 52R more effectively (without detrimentally affecting the promotion of the s 52A purpose); or
 - 2.49.3 significantly reduce compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s 52A purpose).
- 2.50 We have also considered the s 53A ID purpose to the extent we have considered changes to the ID requirements:
- 2.50.1 the purpose of information disclosure is to ensure that sufficient information is readily available to interested persons to assess whether the Part 4 purpose is being met.³²
- 2.51 We have also considered, where relevant, whether there are alternative solutions to the identified problems with the IMs and ID that do not involve changing the IMs.

What is the policy intent of the related party transactions provisions and is it still relevant?

- 2.52 We have expressed the policy intent in various documents over time as summarised below. The words used in each instance are not exactly the same, but the key principles from our documents are.
- 2.53 Our concern is that suppliers of regulated services have the ability to use an unregulated related party to increase overall profits by overcharging for inputs supplied by the related party. Such inputs into the regulated service may be over-priced, as the supplier of the regulated service and the unregulated related party have a common profit incentive.

³² S 53A of the Act.

- 2.54 Therefore our policy intent is to ensure:
- 2.54.1 related party transactions are treated and expressed in a way that is akin to transactions made at arm's-length values and terms; and
 - 2.54.2 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.

What we said in 2010 in the development of the input methodologies

- 2.55 In our 2010 paper, our intention behind the development of our related party transaction provisions in the IMs was:³³

Without the discipline of arm's-length negotiation, which is essentially where the price paid for an asset may be greater (or less) than an asset's market value, there could be a transfer of value between an EDB or GPB and consumers that would not otherwise occur. To address this concern, the Commission considers that where a regulated supplier buys an asset from a related party, the asset's RAB value should not be based on the purchase price, but instead on some objective, independent measure.

What we said in 2012 when putting in place the information disclosure requirements

- 2.56 In our 2012 paper, our intention behind the related party transactions ID requirements was to enable interested persons to understand whether the information disclosed may be affected by related party dealings.
- 2.57 In setting ID requirements we considered the value placed on services supplied by related parties and revenues received from a related party. The policy intent in our ID determinations is similar to that of the IMs. ID also requires the value of related party transactions to be based on, or linked to, objective verifiable information. This information should help demonstrate that the price approximates that which could be expected in an arm's-length transaction.³⁴

³³ Commerce Commission "Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" December 2010, E8.8, E8.9. In referring to GPB, we mean gas pipeline business.

³⁴ Commerce Commission "Information Disclosure Requirements for Electricity Distribution Businesses and Gas Pipeline Businesses Draft Reasons Paper" (16 January 2012), A1.36.

2.58 In particular, the related party transactions provisions in ID should allow interested persons to have access to information that discloses:

- 2.58.1 the existence and extent of related party transactions;
- 2.58.2 what the related party transactions relate to;
- 2.58.3 whether the price is the same or similar to the price which would be expected in an equivalent arm's-length transaction (and if not, what adjustment is required to make it similar to an arm's length price); and
- 2.58.4 whether the price is based on objective verifiable information.

What we said in our June 2016 Topic Paper

2.59 In our June 2016 Topic Paper we outlined the following policy intent:³⁵

To ensure that related party arrangements cannot be manipulated by regulated suppliers in a way that allows them to extract excessive profits.

2.60 In its submission on the topic paper, the Electricity Networks Association (ENA) noted:³⁶

We are not convinced the policy intent stated in the related party paper (to ensure that related party arrangements cannot be manipulated by regulated suppliers in a way that allows them to extract excessive profits") is meaningful. The intention should be to provide for the fair recovery of costs, at arm's-length prices, with consistency between EDBs and transactions based on evidence (as with the current related party requirements, there should also be the ability to apply less stringent rules in de minimis situations).

2.61 In our view, this submission from the ENA appears to focus on the outcome instead of the intent itself. Whilst a "fair" recovery of costs may be an outcome of applying arm's-length principles; we do not consider this a necessary requirement of the related party transaction regime. This is because we would not wish to promote a "fair" recovery where a related party may be grossly inefficient.

Continued policy relevance

2.62 We consider the policy intent of the related party transactions provisions is still relevant for both the IMs and ID. We have seen nothing in our review which suggests that the policy intent for this regime should change.

³⁵ Commerce Commission "Input Methodologies review draft decisions: Topic paper 7: Related party transactions" (16 June 2016), X3.

³⁶ ENA "Input Methodologies review - Topic paper 7, related party transactions" (4 August 2016), p.4.

Could the implementation of the related party transactions provisions be improved?

- 2.63 In line with the IM review framework, we next assess opportunities to improve the implementation of the related party transactions provisions.
- 2.64 While we are still comfortable with the policy intent behind the related party provisions, our review so far has identified two problems with the way the related party regime has been implemented. We consider that there may be opportunities to improve the way we have implemented the rules to better give effect to the policy intent and to reduce compliance costs.
- 2.65 These problems and our proposed solutions to these are set out further in this paper.

Chapter 3 Overview of our initial findings

Purpose of this chapter

- 3.1 This chapter provides an overview of the initial findings from our analysis of the related party transactions regime to date.
- 3.2 In particular, it provides:
 - 3.2.1 an outline of our learnings from our discussions with suppliers of regulated services in the EDB sector;
 - 3.2.2 an outline of our learnings from discussions with EDB sector auditors;
 - 3.2.3 consideration of relevant related party transactions submissions to date; and
 - 3.2.4 a summary of aggregate trends from ID disclosures.

Background

What we wanted to understand from our analysis of the related party transactions regime

- 3.3 We wanted to assess the extent to which the related party transactions regime meets the policy intent and to gain a better understanding of a range of practical matters relevant to the regime.³⁷

Gaining relevant insight

- 3.4 We considered that the best way to gain this initial insight was to do the following:
 - 3.4.1 meet with a selection of EDBs to discuss the current related party transactions regime and the issues raised in our 2016 paper;³⁸
 - 3.4.2 consider submissions already received from independent parties to get an understanding of how related parties may be working in practice; and
 - 3.4.3 consider the trends of related party transactions over time.

³⁷ Commerce Commission “Input methodologies review draft decisions: Topic paper 7 – related party transactions” (16 June 2016), para 78.2.

³⁸ Commerce Commission “Input methodologies review draft decisions: Topic paper 7 – related party transactions” (16 June 2016), para 74.

- 3.5 In considering how the related party provisions are currently applied, we wanted to speak to people connected with a broad sample of EDBs. When selecting the EDBs to talk with we therefore considered the following attributes:
- 3.5.1 size of the EDB;
 - 3.5.2 whether the EDB provides exempt or non-exempt services;
 - 3.5.3 geographical location of the EDB (ie, we considered both rural and city-based EDBs);
 - 3.5.4 the application of the current regulatory rules as reported by the EDB in ID documentation;
 - 3.5.5 governance and internal controls of the EDB and its related parties; and
 - 3.5.6 the EDB's consideration of contestability in the procurement of services from a related party.
- 3.6 To help inform our definition of the problem, we also met with representatives of various auditing firms providing assurance reports on entities in the EDB sector to discuss the level of difficulty faced by them in providing such reports with respect to the related party transactions regime.
- 3.7 Discussions with EDBs and auditors helped us to understand the various company structures in the industry and the use of the various regulatory options selected by EDBs for valuing transactions between an EDB and its related parties.
- 3.8 We thank those that participated in the discussions with us. The response we had from the EDBs and sector auditors was valuable in providing us with useful background.
- 3.9 To date we have had limited submissions from independent parties. We welcome input from contractors seeking to provide services to regulated suppliers that may be relevant to our review of the related party transactions regime. This may include any evidence of your experience in providing services to regulated suppliers.

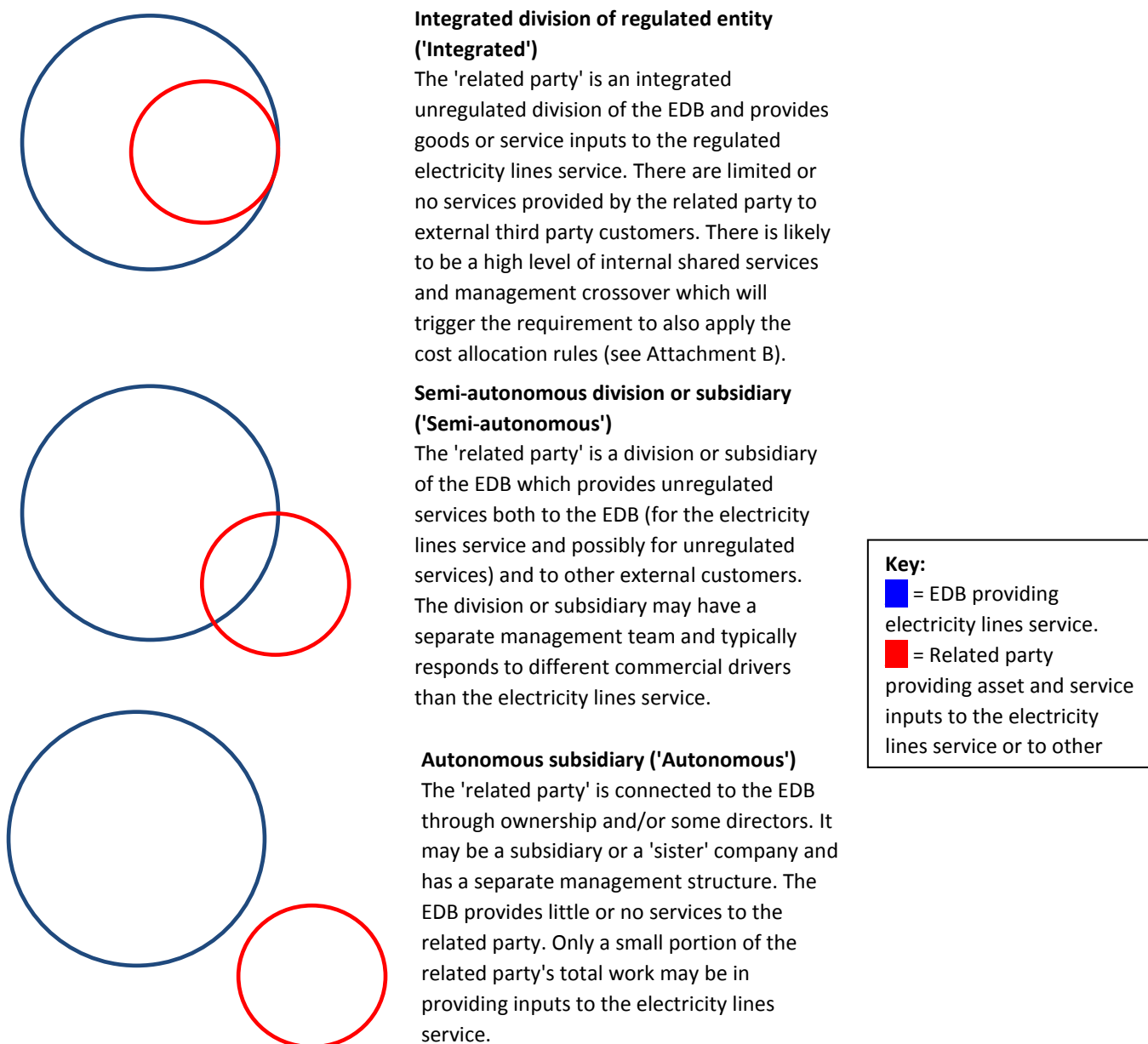
Learnings from our discussions with a sample of electricity distribution businesses

Types of ownership structures

- 3.10 One observation we made from our discussions was that there does not seem to be any dominant ownership or operating structure in the EDB sector. Company structures seem to fall into three broad typical categories, as we have outlined in Figure 3.1 (ie, integrated, semi-autonomous, and autonomous).

- 3.11 Even within those broad categories, key operating features may vary, such as the degree of commonality in management structure or board governance.

Figure 3.1 Typical electricity distribution businesses and related party structures for providing services



- 3.12 Given the various types of company structures, we consider our related party provisions must be able to be applied in multiple and often complex scenarios.

Reasoning for ownership structures

3.13 As the regulator, our regulation is focused on ensuring the Part 4 purpose is met through the provision of the regulated services. It is not the intention of our related party provisions to influence the selection of the business structure in a way which negatively impacts the efficiency of the regulated service.³⁹

3.14 Based on our discussions, EDBs have a range of reasons for the operating and ownership structures they have selected. We noted two main considerations, which could be distilled as:

3.14.1 Imperfect local markets:

3.14.1.1 In smaller regional markets (ie, isolated communities), EDBs may have fewer choices of service providers and may face difficulties in attracting third party contracting service companies and some specialist services to the area to get the services required. These can be due to less financial incentive to move away from the major cities or less desire to live in the area. We refer to this issue as imperfect local markets. We note there also may not be enough work in smaller regional markets to sustain a standalone business.

3.14.1.2 We think it is important to note at this point that during our 2012 review of ID, regulated suppliers noted difficulty in identifying market prices for some acquired services, with many suppliers unable to objectively identify how to demonstrate that transaction prices were equivalent to an arm's-length price.⁴⁰ Those comments seem consistent with where we are now and a need to make further refinements to the regime.

³⁹ We acknowledge this in response to Deloitte's comment that in the case of Aurora, there is too much focus on the related party rules within the respective companies and this has the ability to influence behaviours. Deloitte "Dunedin City Holdings Limited - Review of Aurora Energy Limited / Delta Utility Services Limited - Network Safety Concerns" (December 2016).

⁴⁰ See Commerce Commission "Information Disclosure Requirements for Electricity Distribution Businesses and Gas Pipeline Businesses Draft Reasons Paper" (16 January 2012), para A1.48.

3.14.2 Economies of scale:

- 3.14.2.1 A number of EDBs share services across the business or group to drive cost savings. In some cases, this can lead to the amalgamation of corporate services at a group level so as to drive efficiencies.
- 3.14.2.2 Some regional EDBs have diversified their first response team by adding opex and minor capex work on the lines to drive efficiency gains with the full utilisation of qualified staff on hand.

Terms of contracts with related parties

- 3.15 We wanted to understand whether the contracts between the related parties and regulated suppliers had features consistent with arm's-length transactions. In our discussions with some suppliers, they described their procurement process.
- 3.16 Several EDBs with closely linked related parties (integrated or semi-autonomous in company structure), have procurement processes that initially prioritise the utilisation of resources of the contracting operations. This often meant that the related party providing contracting services completed the majority of opex on the lines, with major capex builds (such as substations) being put out to tender due to the limitations on resources.
- 3.17 We understand that any rational profit motivated commercial business would want to keep its workforce highly occupied. However, we currently have limited transparency about this, as we do not have the visibility of the underlying policies and transactions of the regulated supplier.
- 3.18 This example of a procurement process (widely used) does not appear to have the rigour we would expect to see in demonstrating an arm's-length relationship.

Mix of business undertaken by related parties

- 3.19 In discussions with EDBs we were able to see a pattern of the main services commonly provided by related parties to EDBs. These services are outlined in Table 3.1.

Table 3.1 Services commonly provided by electricity distribution businesses' related parties

Type of service	Services commonly provided
Contracting services	Contracting services, including: <ul style="list-style-type: none"> • First response • New build - minor/major • Routine maintenance and operating • Vegetation management
Corporate services	Corporate management services, including: <ul style="list-style-type: none"> • Payroll • Finance
Communications	Communication services, including: <ul style="list-style-type: none"> • SCADA • Fibre

Learnings from our discussions with sector auditors

- 3.20 We approached auditors completing assurance reports for EDB ID purposes to help understand how the auditors are applying the rules.
- 3.21 The auditors advised us that their audit and assurance reviews involving our regulations require a significant level of audit judgement and making judgements around the margin. They also noted that the complexity of the rules and their prescriptiveness can lead to various interpretations of classification and measurements.
- 3.22 We discussed the workability of the current regime with auditors from Deloitte, the Office of the Auditor General (**OAG**) and PricewaterhouseCoopers (**PwC**).

Deloitte discussion

- 3.23 The majority of Deloitte's auditor focus is forming judgements around the margin and looking at the recoveries of overheads. It notes that the related party transactions rules are complex and it has had to resolve issues with an audit client on the varying interpretations of the rules, particularly the classification and measurement of related party transactions.

- 3.24 In assessing the reasonableness and consistency of the transactions it makes assumptions about the cost drivers and whether the assigned cost is reasonable. In assessing acceptable margins it considers external evidence. It noted that the more prescriptive the Commission makes the rules the harder it is to interpret the regime.
- 3.25 Deloitte noted that GAAP requires an overhead recovery as part of capex, which is distinct from the 17.2% margin approach under our rules. In comparison with the 17.2% margin on direct costs, it has observed that external margins on transformers are as low as 10% and margins on other cost items can be upwards of 25%. At times, there is ambiguity as to the application of this margin concept in reporting groups, whereas GAAP internally generated margins must be eliminated on consolidation at the group level.
- 3.26 Deloitte noted that based on the approach applied by auditors, it would support a more principles-based approach to our rules (eg, based on a statement of purpose), with questions which support the reasonableness of the value of the transaction, and that such an approach should be able to be applied cross sector.

Office of the Auditor General discussion

- 3.27 The OAG observed that the valuation options vary in their complexity, with quite significant levels of judgement required. The directors' certification option is generally being used in two circumstances:
- 3.27.1 when none of the other options are feasible; or
- 3.27.2 where suppliers may be going to that option for the simplest approach.
- 3.28 However, the OAG noted that from an audit perspective this method does not demonstrate a valuation approach.
- 3.29 The OAG noted that suppliers may be selectively picking valuation options to get the answer they want on each transaction and would like to see a clearer hierarchy of the valuation options. It would also like to see a clearer definition and description of what directly attributable costs are and how they are to be determined by suppliers.
- 3.30 In contrast to the Deloitte comments, the OAG thinks that principles-based rules could be more open to interpretation and less effective for the Commission. However, it suggested providing worked examples with the various valuation options.
- 3.31 The OAG suggests the Commission includes an option for early adoption of any amended rules by regulated entities. The OAG would also like to have a greater understanding as to the level of assurance the Commission wants from auditors.

PricewaterhouseCoopers discussion

- 3.32 PwC considers that the related party transactions provisions should ensure the “fair recovery” of direct and indirect costs by regulated entities in a sector and this should apply irrespective of the company structure used to operate the regulated service.
- 3.33 Overall, PwC finds the interpretation of the current related party transactions regulatory rules achievable. One area that does cause interpretation issues is our move away from the GAAP related party definition to also consider internal divisions providing unregulated services as related parties.
- 3.34 PwC has seen examples of suppliers of regulated services restructuring to make it easier to comply with our rules. It has also seen suppliers using the directors’ certification valuation option for the disclosure of related party transactions due to difficulty in complying with the other options for some businesses.
- 3.35 In addressing the problems with the related party transactions regime, PwC would like the Commission to consider desired outcomes and then work back to the appropriate methodology.

Consideration of relevant stakeholder submissions to date

- 3.36 In our assessment of whether the current rules are meeting the policy intent, we considered those submissions received to date through the IM review process. Table 3.2 provides an outline of the previous relevant submissions to date and our key observations.
- 3.37 We note that we have received limited comments from contractors attempting to provide services to suppliers providing regulated services. In particular, we would be interested in any evidence on the extent to which the current related party transactions rules are not achieving outcomes consistent with the Part 4 purpose.

Table 3.2 Summary of key submissions from stakeholders

Stakeholder	Stakeholder comments	Our key observations
Asplundh ⁴¹	<p>Asplundh would like to see network owners delivering competitive or value for money services to customers.</p> <p>Its submission notes approximately 8 of 29 EDBs utilise external vegetation management service providers, with only some of these applying competitive market tendering processes. Its view is that currently between 50-80% of network vegetation opex is delivered in-house or by contractors selected using limited competitive processes.</p> <p>Asplundh has seen situations where network vegetation management services can be delivered by experienced external service providers more cost effectively than internal contracting services. Quoting examples where we are 33% (or greater) more cost effective than the current internal contracting services.</p>	<p>Asplundh's submission implies some EDBs have a preference for internal services rather than looking wider for the most competitive offer.</p> <p>These comments support our concern that not all related party transactions are at values akin to arm's-length terms. This could lead to combined excessive profits in the group through the provision of the regulated service. This could adversely affect the consumer through higher prices.</p>
Electricity Retailers of New Zealand (ERANZ) ⁴²	<p>ERANZ notes that use of competitive tendering processes in the related party transactions rules by international regulators with the goal being to ensure viable market options are not pre-empted.</p>	<p>We acknowledge that competitive tendering processes enables greater transparency for achieving transaction values akin to arm's-length. We consider this in our proposed solutions in Chapter 5.</p>

⁴¹ Asplundh "Input Methodologies Review - draft decisions, topic 7: Related Party Transactions" (11 August 2016).

⁴² ERANZ "ERANZ Cross-submission to the Commerce Commission on Input Methodologies for Emerging Technology" (18 August 2016).

Stakeholder	Stakeholder comments	Our key observations
Contact Energy ⁴³	<p>Contact notes that the Commission should be wary of arguments by EDBs that there are constraints which require in-house investment over contracting with a third party.</p> <p>Contact is concerned with valuation methods which consider the percentage of related party transactions to opening RAB, total cost of assets or total revenue for regulated services. This is because these disclosure options enable EDBs full discretion over the price paid.</p>	<p>We acknowledge that some current valuation options may not be meeting the policy intent of the related party regime. This is discussed further in Chapter 4.</p>
Counties Power ⁴⁴	<p>Counties Power supports a blended model with contracting services, comprising of in-house crews supported by specialist external providers such as Asplundh.</p> <p>Counties notes that a good procurement strategy avoids supplier underperformance, high administration costs from repeated tendering, potential for a shrinking supplier market and will seek to achieve best value for money over whole of life.</p> <p>It also notes that sourcing arrangements are not all about cost, but also responsiveness, control, customer experience and risk management, in particular health and safety.</p>	<p>We acknowledge that structured procurement policies can provide greater assurance that related party transactions are akin to arm's-length.</p> <p>We also understand that suppliers of regulated services may choose a reason other than cost to use an in-house supplier; however, the price paid by consumers should not reflect excess charges.</p>
PwC ⁴⁵	<p>PwC notes interpretation and implementation issues with key terms and concepts such as directly attributable costs, directors' certification and the 17.2% margin.</p>	<p>We acknowledge that there are interpretation and implementation issues with the current related party provisions and these are addressed in Chapter 4.</p>

⁴³ Contact Energy "Input Methodology Review" (4 August 2016).

⁴⁴ Counties Power "Cross-submission: Input Methodologies Review - draft decisions (Topic 7: Review Party Transactions)" (18 August 2016).

⁴⁵ PwC "Submission to the Commerce Commission on Input methodologies review: draft decisions paper" (4 August 2016).

Summary of aggregate trends from information disclosures

Related party transactions trends

- 3.38 We have observed some trends with related party transactions in information disclosures made by regulated suppliers.
- 3.39 These trends (graphed below) are of interest to us, as they show related party transactions are significant. Therefore, if the regulation is not implemented properly, the potential impact on consumers of any problems could be significant. Our key points to note from these trends are:
- 3.39.1 related party transactions across the sector are large and growing; and
 - 3.39.2 related party transactions as a proportion of total opex and total capex are large and growing.
- 3.40 For example, we note the average related party proportions of total opex and capex were 30% for EDBs based on the 2016 information disclosures. However, some EDBs have as much as 95% of total opex being provided by a related party and 100% of total capex being provided by a related party.
- 3.41 Thus, we have interest in:
- 3.41.1 the change in absolute dollar value of related party transactions over time (Figure 3.2);
 - 3.41.2 the value of related party transactions to total opex and capex over time (Figure 3.3);
 - 3.41.3 the percentage of related party transactions of EDBs to total opex and capex in 2016 (Figure 3.4); and
 - 3.41.4 the use of various disclosure options across opex and capex in 2016 (Figure 3.5 and 3.6).

Figure 3.2 Change in absolute dollar value (\$000's) of related party transactions over time⁴⁶

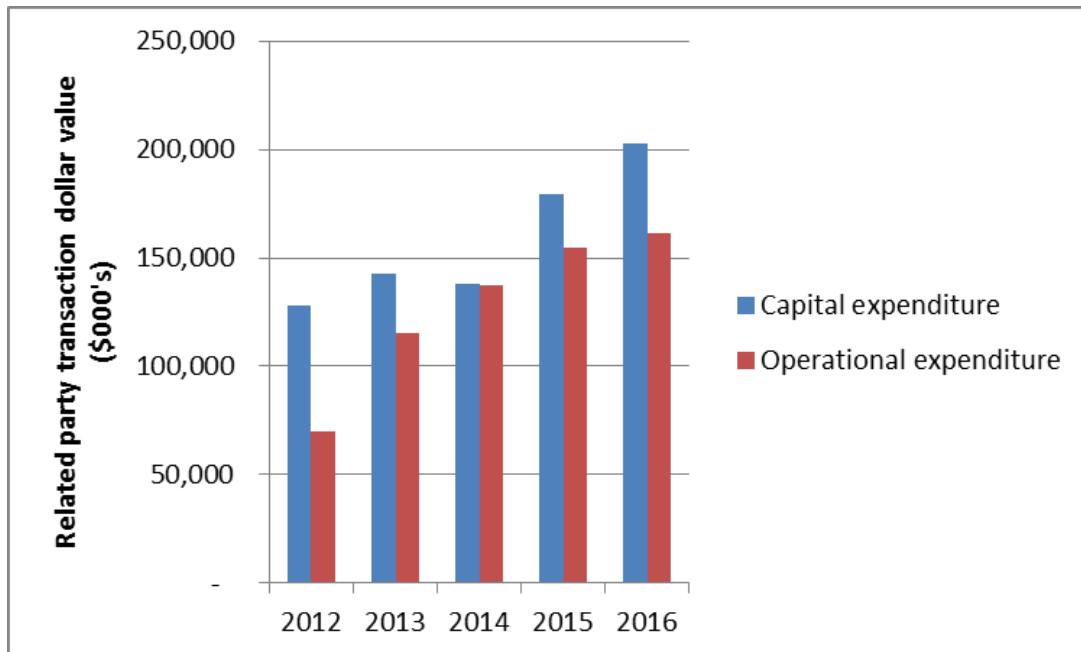
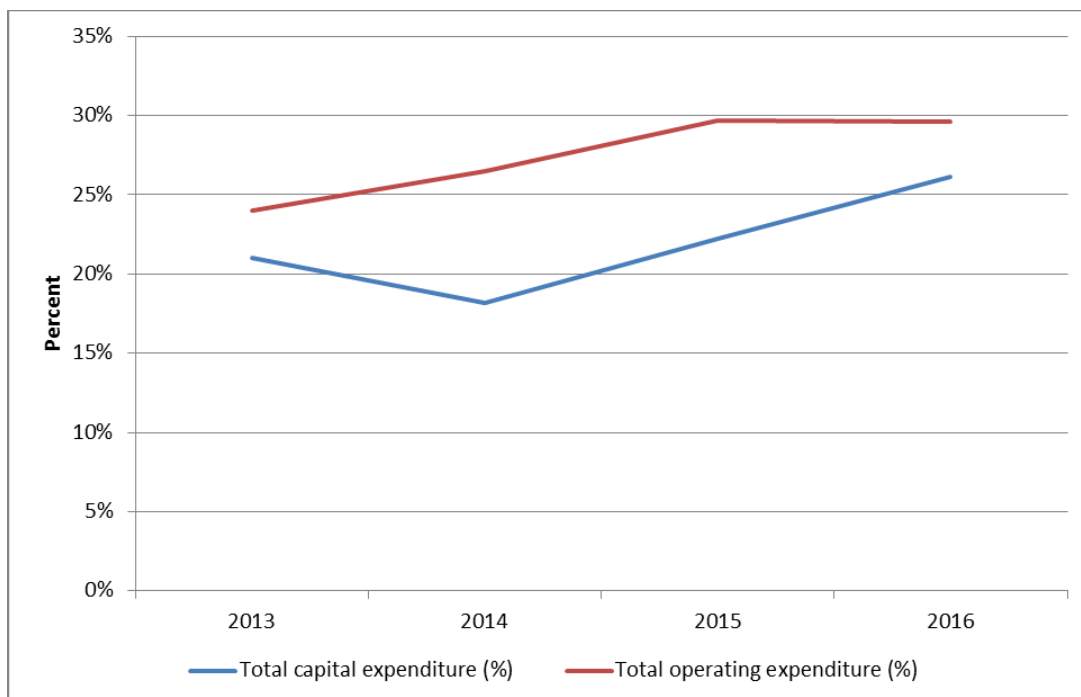


Figure 3.3 Proportion of electricity distribution businesses' total opex and capex from related parties 2013-2016⁴⁷



⁴⁶ Sourced from Commerce Commission analysis of information disclosures made by regulated suppliers.

⁴⁷ Sourced from Commerce Commission analysis of information disclosures made by regulated suppliers.

Figure 3.4 Percentage of electricity distribution businesses' related party transactions to total opex and capex in 2016⁴⁸

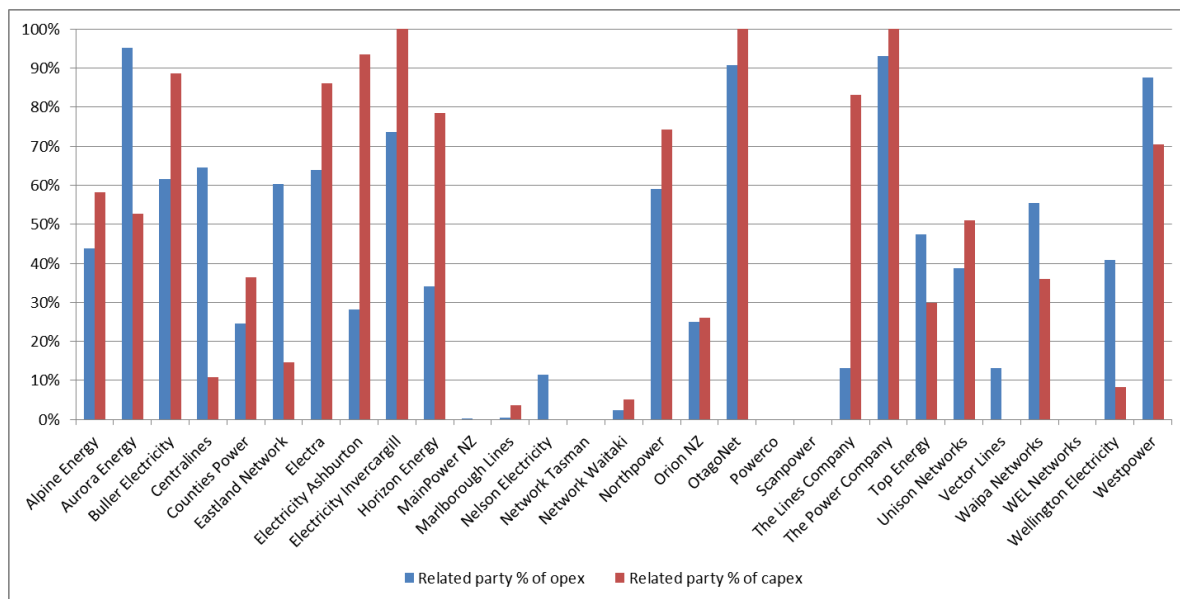
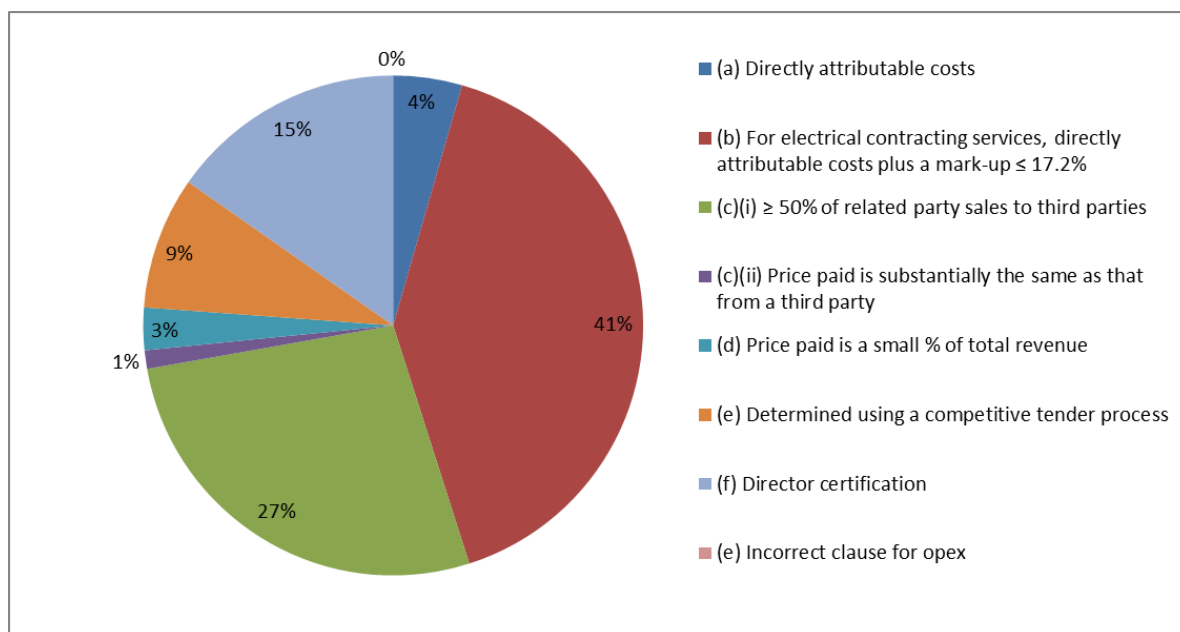


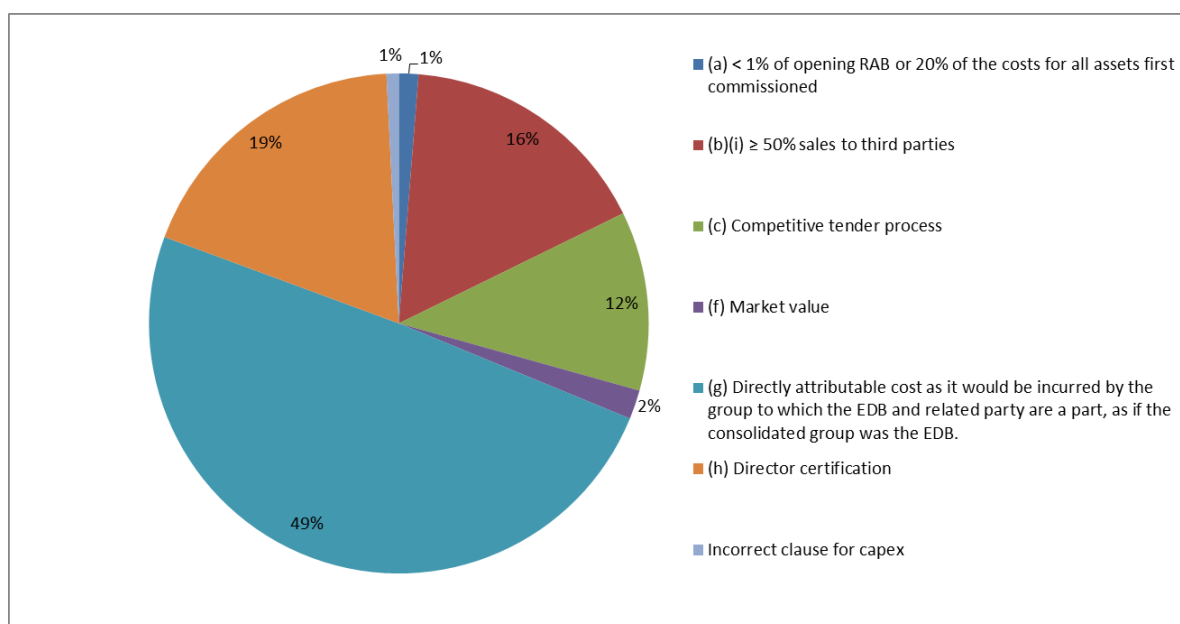
Figure 3.5 Use of related party disclosure options across opex in 2016⁴⁹



⁴⁸ Sourced from Commerce Commission analysis of information disclosures made by regulated suppliers.

⁴⁹ Sourced from Commerce Commission analysis of information disclosures made by regulated suppliers.

Figure 3.6 Use of related party disclosure options across capex in 2016⁵⁰



Implementation and compliance issues reflect problems that affect the industry

3.42 The extent to which the implementation and compliance issues reflect the problems is seen through the following symptoms:

3.42.1 Confusion between ID and the IMs, for example:

3.42.1.1 Suppliers of regulated services continue to inappropriately apply IM capex rules to opex or vice versa. For example, in its 2016 disclosures, Marlborough Lines Limited disclosed related party capex applying ID opex rules.⁵¹

3.42.1.2 Various submissions support the parallel review of the related party provisions across ID and IMs to ensure that the two determinations are consistent.⁵²

⁵⁰ Sourced from Commerce Commission analysis of information disclosures made by regulated suppliers.

⁵¹ As outlined in Marlborough Lines Limited 2016 Information Disclosure available at <http://www.marlboroughlines.co.nz/About-us/Disclosures/Financial-and-Company-Performance.aspx>

⁵² As supported by Alpine Energy "Submission to the Commerce Commission on Input Methodologies review: draft decisions papers" (4 August 2016), para 33.

3.42.2 Misunderstanding and varying interpretation of key concepts, for example:

- 3.42.2.1 In its submission on the IM review, PwC noted that additional clarity is needed on directly attributable costs, directors' certification and the consideration of the 17.2% margin.⁵³
- 3.42.2.2 In discussions with selected EDBs, they noted the difficulty in determining what costs were to be considered directly attributable. The ENA also notes this interpretation concern with 'directly attributable costs' which is a term separately defined for cost allocation purposes.⁵⁴
- 3.42.2.3 In discussions with sector auditors, they noted that the move away from the GAAP definition for related parties often lead to confusion as to its application.
- 3.42.2.4 Alpine Energy's submission on the IM review outlined issues with the application and usability of the related party transactions rules.⁵⁵

3.42.3 Information disclosures providing us with limited transparency with methodology options and supporting documentation.

- 3.42.3.1 As visible in Figures 3.3 and 3.4, there are still a number of EDBs disclosing using director certification. This method provides us with limited transparency of the valuing of transactions.

3.43 Currently, the related party regulatory regime provides a number of disclosure options. It appears EDBs have preferred disclosure options as visible in Figures 3.5 and 3.6 above. There is a tendency to default to options like the director certification or 100% directly attributable options.

⁵³ PwC "Submission to the Commerce Commission on Input methodologies review: draft decisions paper" (4 August 2016).

⁵⁴ ENA "Input Methodologies review - Topic paper 7, related party transactions" (4 August 2016).

⁵⁵ Alpine Energy "Submission to the Commerce Commission on Input Methodologies review: draft decisions papers" (4 August 2016), para 30.

3.44 Some entities noted that some other options were unable to be applied to their situation. In Aurora's submission on the IM review draft decision, it noted that the related party rules should be reviewed to ensure they can be applied in the circumstances where they are appropriate.⁵⁶ Unison also supported this review noting that the current rules do not readily apply to some types of transactions.⁵⁷

⁵⁶ Aurora "Input Methodologies Review: Draft Decision and Determination Papers" (4 August 2016).

⁵⁷ Unison "Submission on the Input Methodology Review" (4 August 2016), para 21.

Chapter 4 Our emerging views on the problem

Purpose of this chapter

- 4.1 This chapter provides an overview of our views on the problems with the current related party transactions regulatory regime.

The problems

- 4.2 At the highest level, we have identified the following broad problem with the regime that:
- 4.2.1 The current practical application of the related party provisions is not well aligned with the policy intent.
- 4.3 This can be further broken down into two problems with a common linked potential harm:
- 4.3.1 Aspects of the way we have designed and implemented the related party transactions rules raises a risk that we will not achieve the related party transactions policy intent (problem one); and
 - 4.3.2 Aspects of the way in which some regulated suppliers have applied the rules also raises the risk that the related party transactions policy intent is not being achieved in practice (problem two).
- 4.4 We see our role as being to create rules that support regulated suppliers in meeting the arm's-length policy intent. Our related party provisions are aimed at requiring regulated suppliers and their related parties to demonstrate that the transactions between them are akin to arm's-length terms and values. To achieve this, our related party rules must be workable and applicable in the wide range of supplier circumstances.
- 4.5 We have outlined the above problems based on our discussions with a sample of EDBs and sector auditors, submissions received during the IM review, and information gathered through our review of ID over time.

- 4.6 As a result of the two identified problems, the value at which an asset or service is transferred from a related party to a regulated service may not be consistent with an arm's-length transaction. This is a situation we wish to avoid, as it could frustrate the achievement of the Part 4 purpose.⁵⁸

What we considered in reaching our emerging views on the problem

- 4.7 In designing and implementing our rules we provided a number of valuation and disclosure options which may not be achieving our intended outcomes. This is because we understand some of the prescriptive options we originally designed may not be usable in a number of typical company ownership and operating structures.
- 4.8 In understanding the two problems identified above, we have analysed the context and issues under the following headings:
- 4.8.1 imperfect local markets consideration;⁵⁹
 - 4.8.2 complexity in terminology and understanding of terminology;
 - 4.8.3 transparency of disclosures; and
 - 4.8.4 compliance with the prescribed rules.
- 4.9 Tables 4.1 and 4.2 provide explanations of the problems and our view of their potential impact on consumers. These tables outline the following:
- 4.9.1 what we are seeing from our discussions with the sample of EDBs, auditors and in the ID reporting, and how this points to the problems;
 - 4.9.2 the effect the focus areas are having on the identified problems; and
 - 4.9.3 a consideration of the materiality for consumers.

⁵⁸ Our policy intent is outlined in Chapter 2 of this paper. Table 2.1 sets out the regulatory objectives consistent with Part 4 and considers the outcomes and risks that related party transactions can have on the achievement of these objectives.

⁵⁹ In referring to thin markets, we are referring to the market for services sought by the regulated supplier. An EDB example is having electrical contracting services readily available in the EDB location. This is a contextual factor.

Table 4.1 Problem with the nature of our design and implementation of the related party transactions regime and potential impact on consumers

Overarching problem	Focus areas	What are we seeing which points to this being a problem?	Effect of the problem	Materiality of potential impact on consumers
Our design and implementation of the regime	Imperfect local market for contracting services	<p>We attempted to design a range of disclosure options that would encompass most foreseeable circumstances such as an imperfect local market for contracting services. Due to the lack of comparative market information, there is a difficulty in measuring an appropriate internal margin for contracting activities provided by an integrated business unit of the regulated supplier or another company in the group.</p> <p>In particular, the provisions provide options for disclosing using a competitive tender process, however only a small number of regulated suppliers disclose using this option.</p>	Valuation of transactions affected in each case. This could lead to transactions not being akin to arm's-length in value, which could adversely affect the consumer.	<p>Medium</p> <p>Not all regulated suppliers face an imperfect local market in assessing whether transactions are equivalent of arm's-length.</p>
	Complexity of terminology	<p>Ambiguity is caused by:</p> <ul style="list-style-type: none"> the rules use some terms that are not as well defined as they could be; and some terms used have more than one meaning within the IMs and more broadly. <p>In particular, the term "directly attributable costs" is used in the cost allocation provisions to mean something different. A "related party" is defined in accounting standards but defined differently for the purposes of our regulatory rules.</p>	Decreased quality of disclosure and potential impact on the valuation of transactions.	<p>High</p> <p>This could have a large impact on the valuing of transactions.</p>

<p>Transparency of our methodology</p>	<p>The way in which the valuation options are drafted can lead to some regulated suppliers defaulting to director certification option. This provides stakeholders with limited transparency in assessing whether the transactions are at the equivalent of arm's-length prices and terms.</p> <p>This also raises questions as to the appropriateness of the methodology if directors are not applying the necessary rigour in providing certification.</p> <p>Further, as set out below, there is a lack of transparency of methodology when this option is selected. The proportion and value of transactions which are being disclosed under this low visibility option are greater than desirable.</p>	<p>Decreased confidence in information disclosure. This makes it hard for us to assess whether any efficiencies are being shared with consumers of the regulated service of if these are being enjoyed by the related party.</p>	<p>Medium</p> <p>Some disclosure valuation options result in limited transparency.</p> <p>We consider the percentage of EDBs using the director certification option is sufficiently material.</p>
<p>Compliance with the prescribed rules</p>	<p>The rules are drafted in a way which has led to some confusion as to which rules apply to opex and capex transactions due to the disconnection of the IMs and ID.</p> <p>In particular, information disclosure still shows some suppliers of regulated services continue to inappropriately apply IM capex rules to opex or vice versa.</p>	<p>Decreased quality of disclosure. Any inconsistent disclosure decreases transparency that transactions are akin to arm's-length values.</p>	<p>Low</p> <p>Some suppliers are showing confusion as to what ID and IMs cover.</p>

Table 4.2 Problem with the nature of regulated suppliers' application of the related party transactions regime and potential impact on consumers

Overarching problem	Focus areas	What are we seeing which points to this being a problem?	Effect of the problem	Materiality of potential impact on consumers
Regulated suppliers' application of the regime	Imperfect local market in contracting services	<p>We are seeing limited separation of governance between management of the related party and the supplier of the regulated service. This combined with a lack of credible benchmarking between the regulated supplier and its various related parties in imperfect local markets means there is less likelihood that related party transactions will be demonstrated to be at the equivalent of arm's-length.</p> <p>In particular, some behaviour shows procurement preference for 'in-house' contracting services, which is also supported by a submission from Asplundh.⁶⁰</p>	Valuation of transactions may be affected. If the input prices paid by the regulated supplier are too high, this would ultimately adversely affect the long term benefit for consumers of the regulated service.	<p>Medium</p> <p>This type of market is not faced by all regulated suppliers.</p>
	Complexity in understanding terminology	Due to the ambiguity of the key defined terms, suppliers have made their own interpretations as to the defining of key terms in the rules, such as directly attributable costs.	Valuation of transactions may be affected. This could lead to combined excessive profits in the group, leading to excessive input costs for the regulated supplier. This would adversely affect the long term benefit for consumers of the regulated service.	<p>High</p> <p>Due to potential impact on the valuation of transactions.</p>

⁶⁰ Asplundh "Input Methodologies Review - draft decisions, topic 7: Related Party Transactions" (11 August 2016).

Transparency of the valuation of transactions	<p>Directors' certification has become the default option to use in disclosing the valuation of related party transactions for some regulated suppliers. This results in a lower level of transparency that prices achieved are akin to arm's-length values as there is no visibility in how directors have satisfied that conclusion.⁶¹</p> <p>In particular, we have seen increased values of related party transactions using director certification in information disclosures and limited or no use of some other valuation options available. There does not seem to be consistent reasoning from EDBs as to the use of this option.⁶²</p>	Decreased confidence in information disclosure. This makes it hard for us to assess whether any efficiencies are being shared with consumers of the regulated service of if these are being enjoyed by the related party.	<p>Medium</p> <p>Not all disclosure valuation options provide for limited transparency.</p>
Compliance with the prescribed rules	The way in which the rules have been drafted has led to some suppliers charging a margin in excess of the 17.2% which was intended to allow for the recovery of overhead costs experienced by the related party. This is either by charging a higher margin and using director certification or by structuring their business in a way to receive a greater combined margin.	Valuation of transactions may be affected. If prices are too high, this could lead to excessive profits in the group, which would adversely affect the consumers of the regulated service.	<p>Medium</p> <p>Our focus is ensuring any efficiency gains made in the use of a related party pass through to the consumer.</p>

⁶¹ We acknowledge that current related party provisions do not require such additional disclosure.

⁶² We note our intention was for director certification to only be used when none of the other options apply. For example, director certification could be used to value a service with high capital costs and low directly attributable costs, which is provided by a related party that does not normally sell similar service to unrelated parties, but when other firms sell similar services. See Commerce Commission "Information Disclosure for EDBs and GPBs Final Reasons Paper" (1 October 2012), para 3.50.

Overall potential harm

- 4.10 Given the fact that the total volume and value of related party transactions are large and growing, we are concerned that the potential for consumer harm could be significant.
- 4.11 We welcome your views on our emerging views on problems with the related party transactions regime. Chapter 5 shares our initial views on potential solutions.

Chapter 5 Initial views on potential solutions

Purpose of this chapter

- 5.1 This chapter provides our initial views on potential solutions to the problems discussed in the previous chapter.
- 5.2 These are only our emerging views of how we may approach any amendments and should not be regarded as limiting other alternatives. We are interested in your views on this in consultation.
- 5.3 Once we have considered submissions, we will be able to provide greater specification of draft solutions in our draft decisions for further consultation.

Our initial views on potential solutions

- 5.4 Our initial views on potential solutions to the problems outlined in Chapter 4 are provided in Table 5.1.

Table 5.1 Potential solutions for problems with the current related party transactions regime

Focus area ⁶³	Potential solutions
Consideration of imperfect local markets in contracting services	<ul style="list-style-type: none"> Consideration of further disclosure requirements to provide increased transparency about procurement policies

⁶³ We have taken our focus areas from our headings outlined in para 4.8.

Focus area ⁶³	Potential solutions
Complexity of terminology and the understanding of such terminology	<ul style="list-style-type: none"> • Clarification of terms through re-defining and/or education; • Reassess: <ul style="list-style-type: none"> ○ directly attributable costs; and ○ 17.2% margin applicable to electrical contracting services • The harmonisation of the related party provisions across the IMs and ID. As outlined in our 2016 topic paper and articulated in various submissions, we would like to see a clear alignment of the related party transactions across ID and the IMs. Our intention with a closer alignment of the provisions across ID and the IMs would be to ensure each preferred option would derive a valuation which was not materially dissimilar. • Better connection of the purpose across ID and the IMs so that regulated suppliers have a clear understanding of the intention behind each method of disclosure. A clearer understanding of the need and objective of our regulatory disclosure and methodology rules would allow regulated suppliers and industry auditors to understand drivers and objectives of preferred outcomes.
Transparency of our methodology and the valuation of transactions	<ul style="list-style-type: none"> • Removal of director certification or inclusion of additional disclosure requirements when disclosing using this less preferred option; • This review may be an opportunity for us to order the disclosure methodologies in preference order. We have a preference for methodologies which demonstrate contestable processes using a tendering or benchmarking process, which increases the likelihood that the transactions will be akin to arm's-length; and • Information disclosure shows that although there are a number of disclosure options available, there are a limited number of options being used by the majority. We believe this review may be an opportunity to streamline options, removing those disclosure options which are not commonly used or appear to impose unnecessary compliance costs.
Compliance and disclosure requirements	<ul style="list-style-type: none"> • The related party provisions should have the ability to stay current to be able to account for new developments in the sector (eg, emerging technology). • Alignment of the methodology and policy intent across the IMs and ID to ensure they both achieve consistent outcomes. We wish to have consideration for those applying the related party transaction rules on a day to day basis in completing this review and in the provision of education material following any amendments. • We are considering more targeted disclosure requirements on the contestability and transparency of procurement processes in achieving the purpose of information disclosure. <ul style="list-style-type: none"> ○ The quality of such procurement processes should be cited and tested by the auditor in providing assurance of the reasonableness of the transaction. Clear and transparent transactional relationships between the related party and the EDB should be visible in this disclosure.

Attachment A Related party transactions provisions overview

Purpose of this attachment

- A1 This attachment sets out the current regulatory requirements for related party transactions across the IMs and ID.

Input methodology determinations

- A2 Part 2 of each of the IM determinations applies related party transactions rules to capex which is included in the value of commissioned assets that enter the RAB for the purposes of both ID and price-quality paths.⁶⁴
- A3 The valuation options available to regulated entities in this respect are set out in Table A1.

Information disclosure determinations

- A4 The ID determinations have valuation rules that cover the cost of commissioned assets and electrical contracting services provided to or from an EDB in transactions between the EDB and related parties, they include a requirement to provide a report on related party transactions (ie, in respect of both capex and opex).⁶⁵
- A5 The valuation options available to regulated entities in this respect are set out in Table A2.

The related party definition is common across IMs and ID⁶⁶

Related party means -

- (a) A **person** that, in accordance with **GAAP**, is related to the **EDB** in question; or
- (b) Any part of the **EDB** in question that does not supply **electricity distribution services**.

⁶⁴ Commerce Commission "Electricity Distribution Services Input Methodologies Determination" (2012), clause 2.2.11(1)(g); Commerce Commission "Gas Distribution Services Input Methodologies Determination" (2012), clause 2.2.11(1)(g); Commerce Commission "Gas Transmission Services Input Methodologies Determination" (2012), clause 2.2.11(1)(g).

⁶⁵ Commerce Commission "Electricity Distribution Information Disclosure Determination" (2012), clauses 2.3.6 and 2.3.7, and Schedule 5b; Commerce Commission "Gas Distribution Information Disclosure Determination" (2012), clauses 2.3.6 and 2.3.7, and Schedule 5b; Commerce Commission "Gas Transmission Information Disclosure Determination" (2012), clauses 2.3.7 and 2.3.8, and Schedule 5b.

⁶⁶ 'Related party' has the meaning defined in the IM determinations and this definition is referenced by the ID determinations.

Table A1 Summary of related party transactions capex valuation options available in the input methodologies⁶⁷

Valuation option	Summary of methodology for determining related party transactions capex values
<p>Small percentage of asset value</p>	<p>The price paid by the supplier of the regulated service for the asset, where the cost of all assets acquired from the related party first commissioned in that disclosure year is less than –</p> <p>(i) one percent of the sum of opening RAB values for the supplier of the regulated service for that disclosure year; or</p> <p>(ii) 20% of the cost of all assets first commissioned by the supplier of the regulated service in that disclosure year.</p>
<p>Comparable pricing</p>	<p>The price paid by the supplier of the regulated service for the asset, where –</p> <p>(i) at least 50% of the related party’s sales of assets are to third parties, and third parties may purchase the same or substantially similar assets from the related party on substantially the same terms and conditions, including price; or</p> <p>(ii) that price is substantially the same as the price paid for substantially similar assets (including any adjustments for inflation using CPI or other appropriate input price index) in the preceding 3 disclosure years from a party other than a related party.</p>
<p>Competitive tender process</p>	<p>The price paid by the supplier of the regulated service to the related party following a competitive tender process, provided that –</p> <p>(i) the price is no more than 5% higher than the price of the lowest conforming tender received;</p> <p>(ii) all relevant information material to consideration of a proposal was provided to third parties, or made available upon request;</p> <p>(iii) at least one other qualifying proposal was received; and</p> <p>(iv) the supplier of the regulated service retains for a period of 7 years following the closing date of tender proposals a record of the tender and tender process, including request for information and/or proposal, the criteria used for the assessment of proposals, reasons for acceptance or rejection of proposals, and all proposals and requests for information on the tender for the purposes of making proposals.</p>

⁶⁷ Commerce Commission “Electricity Distribution Services Input Methodologies Determination” (2012), clause 2.2.11(5); Commerce Commission “Gas Distribution Services Input Methodologies Determination” (2012), clause 2.2.11(5); Commerce Commission “Gas Transmission Services Input Methodologies Determination” (2012), clause 2.2.11(5).

Valuation option	Summary of methodology for determining related party transactions capex values
Depreciated historic cost	Recorded at its depreciated historic cost on the day before the acquisition by the supplier of the regulated service determined in accordance with GAAP.
Inventory value	Recorded at its inventory value on the day before the acquisition by the EDB determined in accordance with GAAP.
Market value	Recorded at its market value as at its commissioning date as determined by a valuer.
Directly attributable costs	Recorded at its directly attributable cost as would be incurred by the group to which the regulated entity and related party are a part, determined in accordance with GAAP, as if the consolidated group was the regulated entity.
Director certification	Recorded at the price paid by the regulated entity for the asset, provided– (i) the price cannot otherwise be determined under paragraphs (a) – (g); and (ii) no fewer than 2 directors of the regulated entity provide a written certification that they are satisfied that the price of any assets determined in accordance with this paragraph reflect the price or prices for those assets that would be received in an arm’s-length transaction; or
No cost	Nil.

Table A2 Summary of related party transactions valuation options in information disclosure⁶⁸

Option	Summary of methodology options for determining related party transactions opex values
Directly attributable cost	<p>Determined at the directly attributable cost incurred by the related party in accordance with the cost allocation process set out in clause 2.1.1 of the IM determination, provided that the cost incurred by the related party in providing the service to the EDB-</p> <p>(i) is fair and reasonable to the EDB; and</p> <p>(ii) is substantially the same as the cost incurred by the related party in providing the same type of services to third parties.</p>
Directly attributable cost plus mark-up	<p>For electrical contracting services or gas contracting services to maintain or develop the network at the directly attributable cost incurred by the related party, determined in accordance with the cost allocation process set out in clause 2.1.1 of the IM determination, plus a mark-up which does not exceed 17.2%.⁶⁹</p>
Comparable costing	<p>At the price paid by the supplier of the regulated service, where -</p> <p>(i) At least 50% of the related party's sales of services or goods, are to third parties and third parties may purchase the same or similar services or goods from the related party on substantially the same terms and conditions, including price; or</p> <p>(ii) the price paid is substantially the same as the price paid for the same or substantially similar services or goods on substantially the same terms and conditions in the preceding 3 disclosure years from a party other than a related party.</p>
Small percentage of total revenue	<p>At the price paid by the supplier of the regulated service where -</p> <p>(i) the price paid for all services, goods, and assets acquired from that related party is less than 1% of the supplier of the regulated service's total revenue from the regulated service for that year; and</p> <p>(ii) the total price paid for all related party transactions is less than 5% of the EDBs total revenue from the regulated service.</p>

⁶⁸ Refer ID determinations clauses 2.3.6 (EDBs and GDBs) and 2.3.7 (GTBs).

⁶⁹ Electrical contracting services include construction and maintenance, network management, vegetation management, connection and disconnection services and load control. See Commerce Commission "Electricity Distribution Information Disclosure Determination 2012 (consolidated in 2015) (24 March 2015). Gas contracting services means construction and maintenance, network management and connection and disconnection services when provided under a contract between the GDB and a related party. See Commerce Commission "Gas Distribution Information Disclosure Determination 2012 (consolidated in 2015)" (24 March 2015).

Option	Summary of methodology options for determining related party transactions opex values
Competitive tender process	<p>At the price paid by the supplier of the regulated service following a competitive tender process, provided that -</p> <ul style="list-style-type: none"> (i) the price is no more than 5% higher than the price of the lowest conforming tender received; (ii) all relevant information material to consideration of a proposal was provided to third parties, or made available upon request; (iii) at least one other qualifying proposal was received; (iv) the final agreement for the provision of the services or goods by the related party does not include any special contract terms; and (v) the EDB retains for a period of 7 years following the closing date of tender proposals a record of the tender and tender process, including request for information and/or proposal, the criteria used for the assessment of proposals, reasons for acceptance or rejection of proposals, and all proposals and requests for information on the tender for the purposes of making proposals.
Director certification	<p>The price paid by the EDB, provided -</p> <ul style="list-style-type: none"> (i) the price cannot otherwise be determined under subclauses (a) to (e); and (ii) no fewer than 2 directors of the EDB provide a written certification that they are satisfied that the price or prices paid for all services and, goods, determined in accordance with this paragraph reflect the price or prices that would be paid in an arm's-length transaction; or
No cost	Nil.

Attachment B Applying cost allocation and related party rules to transactions

B1 Figure B1 of this attachment sets out a decision tree for how the related party transaction rules work with the cost allocation rules under the most common input cost scenarios.

Figure B1 Related party transactions and cost allocation

