

Related Party Transactions ID Requirements

22 March 2018

EAD Regulation Development Team



What rules apply? (1)

Principles-based valuation approach

- The regulated business must complete its valuation of transactions with a related party for ID in accordance with the principles-based approach to the arm's-length valuation rule:
 - Each acquisition is valued at no greater than if it had the terms of an arm's-length transaction
 - The value of the good or service acquired does not exceed the actual amount charged to the regulated business by the related party
 - A sale or supply to a related party is valued at no less than if it had the terms of an arm's-length transaction



What rules apply? (2)

Related party

- Two limbs of the definition may apply (see examples)
- Paragraph (a) definition referenced to the definition of “related party” in NZ IAS 24
- Paragraph (b) definition: “any part that does not supply [regulated services]”

Arm’s-length transaction

- We have adopted wording for “arm’s-length transaction” from the definition in auditing standard ISA (NZ) 550.¹

¹ External Reporting Board (XRB) “International standard on auditing (New Zealand) 550 - Related Parties (ISA (NZ) 550).” Compiled November 2016 and incorporating amendments up to and including October 2016.



What rules apply? (3)

Exercise of judgement

- All related party transactions must meet the arm's-length rule for ID disclosures
- An objective and independent measure of valuation must be used
- When the independent auditor forms its opinion on the disclosures, we expect it to exercise professional judgement in accordance with their assurance standards – see paragraphs 4.35 to 4.45 of the Reasons paper
- We expect the regulated supplier and the independent auditor to discuss the judgement calls on valuation up front to reduce the risk of a modified assurance opinion later being issued



What rules apply? (4)

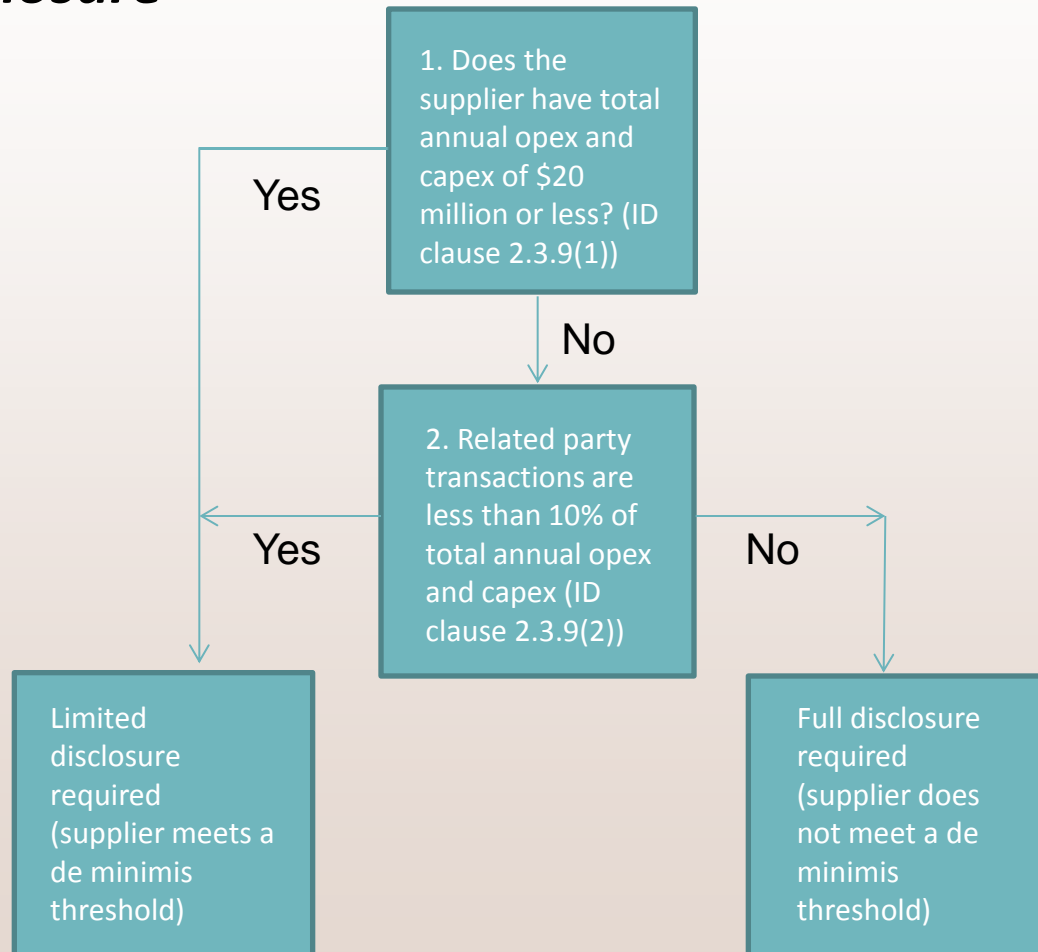
The consolidation option

- Where a transaction is valued for ID disclosure purposes at the cost normally incurred by the related party, and provided this is fair and reasonable to the regulated supplier, for simplicity this may be treated as if it was an arm's-length transaction (IM clause 2.2.11(6) and ID clause 2.3.7)



Levels of disclosure required

The de minimis threshold tests for *full disclosure* and *limited disclosure*



Disclosure requirements (1)

Full and limited disclosures

Requirement	Full disclosure (do not meet a de minimis threshold)	Limited disclosure (meet a de minimis threshold)
Related party relationships	✓	✓
Procurement policies and processes	✓	X
Practical application of the procurement policies and processes	✓	X
Recent examples of market testing	✓	X
Map of anticipated network expenditure and network constraints	✓	X
Valuation methodology	✓	✓
Report on Related Party Transactions (Schedule 5b) ¹	✓	✓
Audit and assurance requirements	✓	✓
Independent report	✓	X



Disclosure requirements (2)

Requirement of limited and full disclosures

- Where a regulated supplier must make either a *limited disclosure* or a *full disclosure*, the disclosure must be of a standard that enables the auditor to state the supplier has complied, *in all material respects*, with our requirement to apply the related party transactions valuation methodology



Disclosure requirements (3)

Impact of materiality in the assurance opinion

- The level of assurance required on disclosures is reflected in the term “in all material respects” (auditor assurance opinion):
 - We expect independent auditors to exercise professional judgement on materiality in accordance with their assurance standards – see paragraphs 4.35 to 4.45 of the Reasons paper
 - We expect auditors to apply the concept of “materiality” from auditing standard SAE 3100 and ISAE (NZ) 3000.²

² Standard on Assurance Engagements 3100 – Compliance Engagements issued by the External Reporting Board in October 2014 and incorporating amendments up to August 2014 and *International Standard on Assurance Engagements (New Zealand) 3000, Assurance Engagements Other than Audits or Reviews of Historical Financial Information*, issued by the New Zealand Auditing and Assurance Standards Board of the External Reporting Board in July 2014



Disclosure requirements (4)

Requirements of limited disclosure

- For related party transactions *limited disclosure* the regulated supplier must disclose as “audited disclosure information”:
 - a diagram or a description showing the connection between the regulated supplier and the related party (ID clause 2.3.8);
 - a report on related party transactions (ID schedule 5b)



Disclosure requirements (5)

Requirements of full disclosure (audited information)

- For related party transactions *full disclosure* the regulated supplier must disclose as “audited disclosure information”:
 - a diagram or a description showing the connection between the regulated supplier and the related party (ID clause 2.3.8)
 - summary procurement policy information (ID clause 2.3.10)
 - practical application of procurement policies and processes (ID clause 2.3.12(1))
 - recent examples of market testing (ID clause 2.3.12(3) to (5))
 - a report on related party transactions (ID schedule 5b)

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Disclosure requirements (6)

Requirements of full disclosure (audited information continued)

- detailed procurement policy information *to be provided to the Commission by the regulated supplier* (ID clause 2.3.11)
- a description of any policies or procedures that require, or have the effect of requiring, a consumer to purchase from a related party items related to the supply of the regulated service (ID clause 2.3.12(2))



Disclosure requirements (7)

Requirements of full disclosure (other information)

- For related party transactions the regulated supplier must publicly disclose:
 - a map of anticipated network expenditure and network constraints (ID clauses 2.3.13 to 2.3.16)



Disclosure requirements (8)

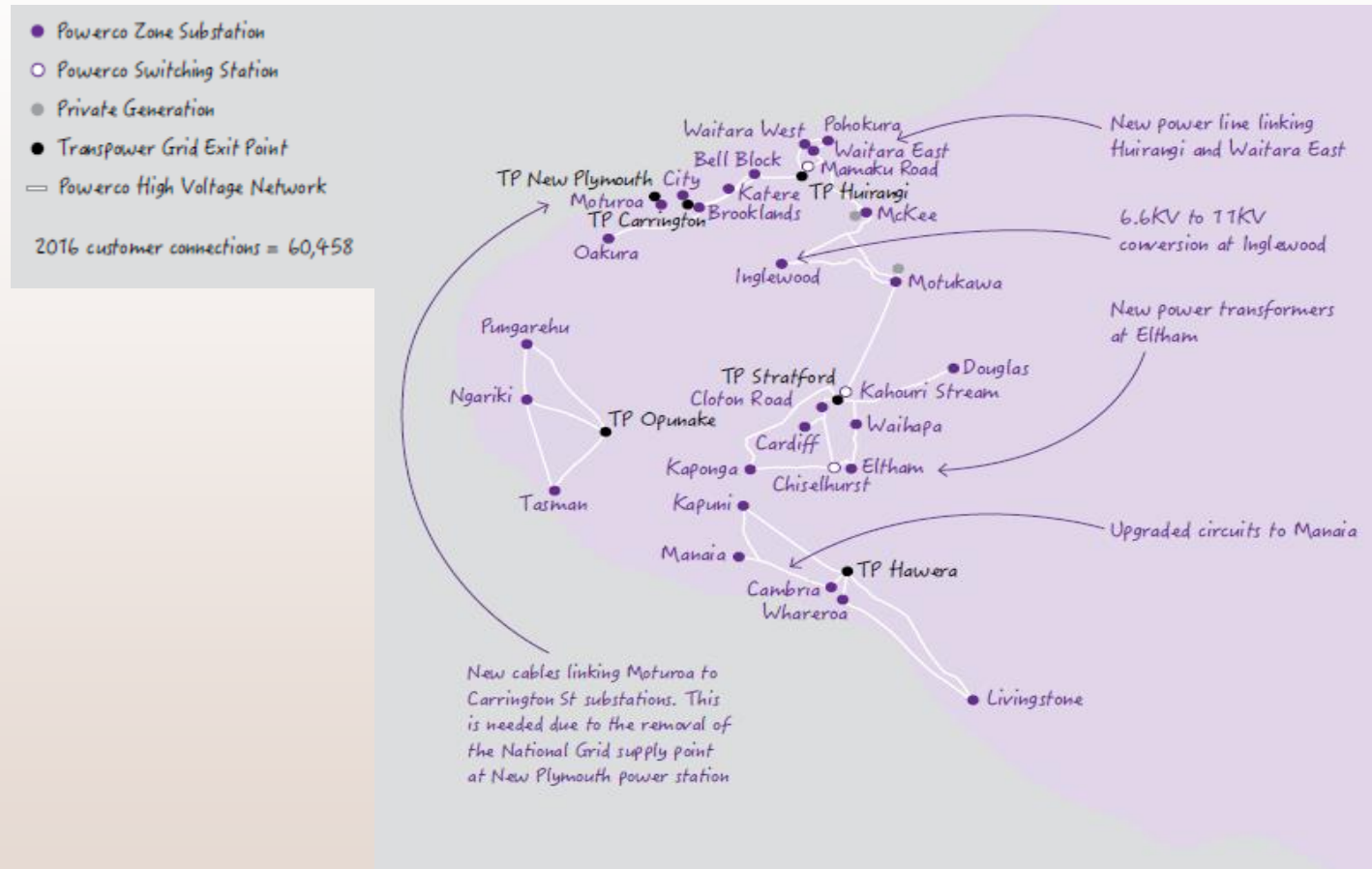
Heat map requirements

- The regulated supplier must mark high level information on a map of its regulated service territory, including identifying their forecast or possible connection with related parties (ID clause 2.3.14):
 - the *10 largest forecast capex projects*
 - the *10 largest forecast opex projects*
 - possible future network or equipment constraints, if the response to that constraint would involve one of the *10 largest future capex projects*
 - possible future network or equipment constraints, if the response to that constraint would involve one of the *10 largest future opex projects*



Disclosure requirements (9)

Example of a heat map



Disclosure requirements (10)

Supplier does not have 10 forecast opex or capex projects

- If a supplier is not forecasting 10 opex or capex projects, the heat map needs to include information about all forecast opex or forecast capex projects:
 - For example, if a supplier has 12 forecast capex projects and 9 forecast opex projects, it will need to include on its map the 10 largest capex projects and all 9 forecast opex projects

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Disclosure requirements (11)

Supplier does not have 10 forecast opex or capex projects (continued)

- If the regulated supplier does not have any forecast opex or capex projects, the heat map need not include information:
 - For example, if a supplier has 20 forecast capex projects and no forecast opex projects, it will need to include on its map its 10 largest forecast capex projects and no forecast opex projects



Disclosure requirements (12)

Responses to network or equipment constraints involve fewer than 10 future opex or capex projects

- Regulated suppliers must mark on the heat map any constraints which will require the use of significant opex or capex projects to respond to each constraint

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Disclosure requirements (13)

Responses to network or equipment constraints involve fewer than 10 future opex or capex projects (continued)

- If responses to possible future network or equipment constraints are currently likely to involve fewer than 10 future opex or capex projects, the heat map will include information about all future opex or capex projects:
 - For example, if a supplier has 20 issues on the network and the response to those issues would be to carry out 5 future opex projects and 7 future capex projects, the heat map will need to include information about all of those possible future projects



Disclosure requirements (14)

The auditor will be required to report on key audit matters (new feature for all ‘audited disclosure information’)

- An assurance report by the independent auditor must in all cases state any *key audit matters* relating to all aspects of the ID assurance report (i.e. not just for related party transactions).³
- Key audit matters:
 - are ID matters reported by the auditor to the Board
 - require significant management judgement relating to the ID disclosures
 - reflect a higher risk of material ID misstatement, require significant auditor attention and have a significant effect on how the assurance engagement is carried out

³see full requirements in ID clause 2.8.1 (2)



Disclosure requirements (15)

No assurance opinion on the heat map

- The independent auditor is *not* required to provide assurance on the map of anticipated network expenditure and network constraints (ID clause 2.3.13 to 2.3.16)



Impact of modified assurance opinion (1)

Guidance on modified opinions

- If the independent auditor concludes that a modified assurance opinion is appropriate in the case of a full disclosure, we have provided guidance - see paragraph 4.42 of the Reasons paper and ID clause 2.8.2(3):
 - Where the auditor is not able to conclude that the valuation of transactions comply in all material respects with the arm's-length valuation rule under full disclosure, this leads to a requirement for the regulated supplier to obtain an independent report (ID clause 2.8.2(3))

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Impact of modified assurance opinion (2)

Guidance on modified opinions (continued)

- We have advised auditors that they should not feel under additional time pressure to conclude on the assurance opinion (other than the general EDB 5 month and GDB 6 month timeframes for publishing assurance reports), as we have allowed for the independent report to be done in the next year if necessary (ID clause 2.8.3)
- In that case, the regulated supplier must disclose a statement of its intention to procure an independent report in the subsequent year



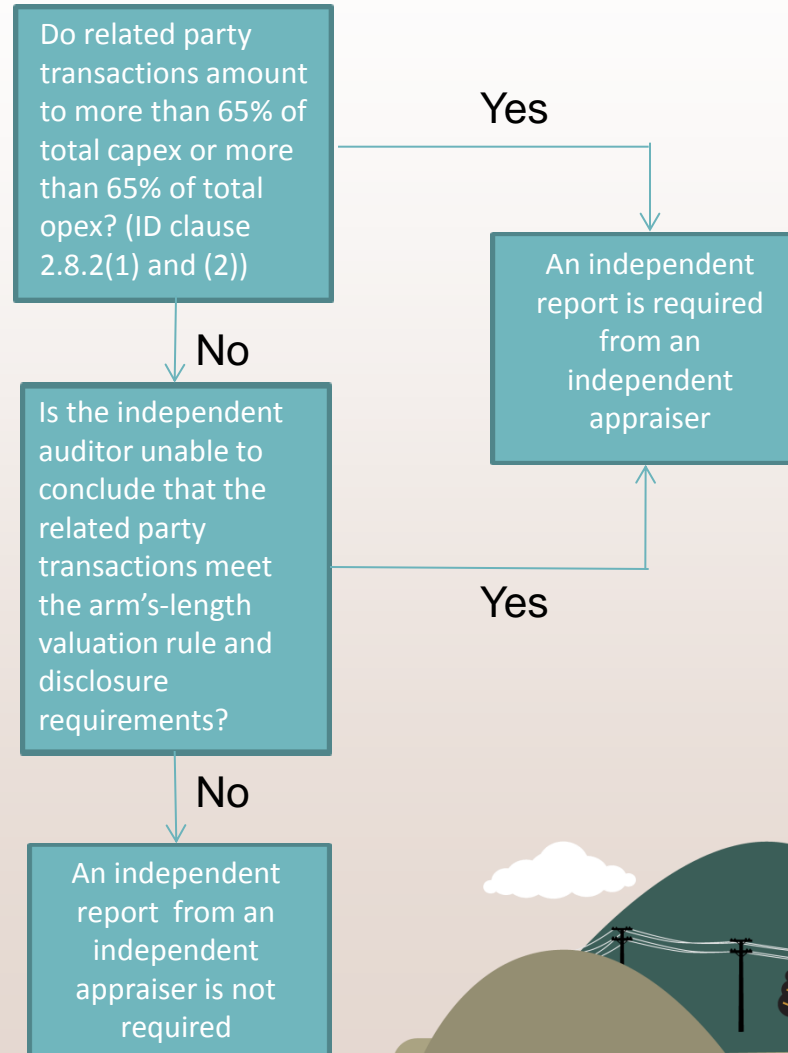
Impact of modified assurance opinion (3)

Consequences of modified opinions

- If a regulated supplier persistently receives a modified assurance opinion in respect of application of the arm's-length valuation rule, this would each time trigger the requirement for an independent report from an independent appraiser
- Although the rule on how often an independent report must be obtained has some relief provisions, if each required independent report also reflects an equivalent modified opinion, the Commission will consider its other regulatory compliance enforcement options



Independent report (1)



Independent report (2)

Independent report not required every year

- An independent report is not required if the regulated supplier meets the de minimis threshold (ID clause 2.3.9)
- An independent report is not required if:
 - the regulated supplier disclosed an independent report for at least one of the last two disclosure years (ID clause 2.8.5(2) **and**
 - the total proportion of related party transactions in each of opex or capex (as applicable) has not increased by more than 5% since the disclosure year addressed in the most recent prior report (ID clause 2.8.5(1))



Independent report (3)

Independent appraiser qualifications

- We expect the independent appraiser to be of a professional standing equivalent to the independent auditor in a field appropriate to the independent report (see also more detail of ID definition of “independent appraiser” paragraph (b))
- The independent auditor can also be the independent appraiser (ID definition of “independent appraiser” paragraph (a))
- The report must set out the qualifications of the independent appraiser to provide the opinion in the report
- We do not at this stage anticipate providing further guidance on choosing independent appraisers



Independent report (4)

Independent appraiser must provide opinions

- The independent appraiser must *provide an opinion* on whether the regulated supplier's related party transactions would comply *in all material respects* with the arm's-length valuation rule, and set out the grounds for that opinion
- It must summarise the steps the regulated supplier has taken to test whether related party transactions comply with the arm's-length valuation rule and whether *in their opinion* these are considered to be reasonable *in all material respects*



Independent report (5)

Independent report is separate from the assurance opinion

- The requirements for the independent report are separate from the ID assurance requirements, but the regulated supplier is free to engage the independent auditor to carry out the role of the independent appraiser (ID definition of “independent appraiser”)
- The independent report must be a separate report from the ID assurance report (ID clause 2.8.4 report requirements generally and ID clause 2.8.4(2) specifically)



Independent report (6)

Materiality (appraiser opinion)

- The level of assurance reflected in the term “in all material respects” (appraiser opinion):
 - We expect the independent appraiser to apply a similar standard of materiality, although this may vary if the appointed person is a member of a different professional body from an independent auditor



Independent report (7)

Modified opinion by the independent appraiser

- If the independent appraiser provides an opinion in the report that the related party transactions would not comply with the arm's-length valuation rule, the appraiser must state their opinion on the alternative transaction terms that could enable compliance with the arm's-length valuation rule (ID clause 2.8.4(4))



Independent report (8)

Reliance by the auditor on the independent report

- Our requirements do not preclude the independent auditor from relying on the independent report to form its assurance opinion if appropriate under the assurance standards
- The auditor will need to consider timing issues which could mean the assurance opinion needs to be issued before an independent report can be completed



Independent report (9)

Other report requirements

- Addressed to the directors of the regulated supplier and to the Commission as the intended users of the report
- Based on the information obtained, sampling of related party transactions and analysis undertaken
- Sets out scope and any limitations of the engagement, including access to information
- States all key assumptions
- Provides a summary of steps taken by the regulated supplier to test whether related party transactions comply with the arm's-length valuation rule



Opportunity for discussion



Outline

- Testing the market
- Related party rules and cost allocation scenarios
 - No related party
 - External related party (a)
 - Internal related party (b) and no cost allocation
 - Internal related party (b) with cost allocation
- Related party transaction and cost allocation guide
- Questions
- Opportunity for discussion



Testing the market (1)

- The arm's-length valuation rule does not require procurement to be demonstrated in a particular way
- Some examples of what a regulated supplier could choose to meet the arm's-length valuation rule:
 - Opening tendering process
 - Comparable pricing
 - Independent market evaluation
- ID clause 2.3.12 outlines what in the procurement process needs to be disclosed

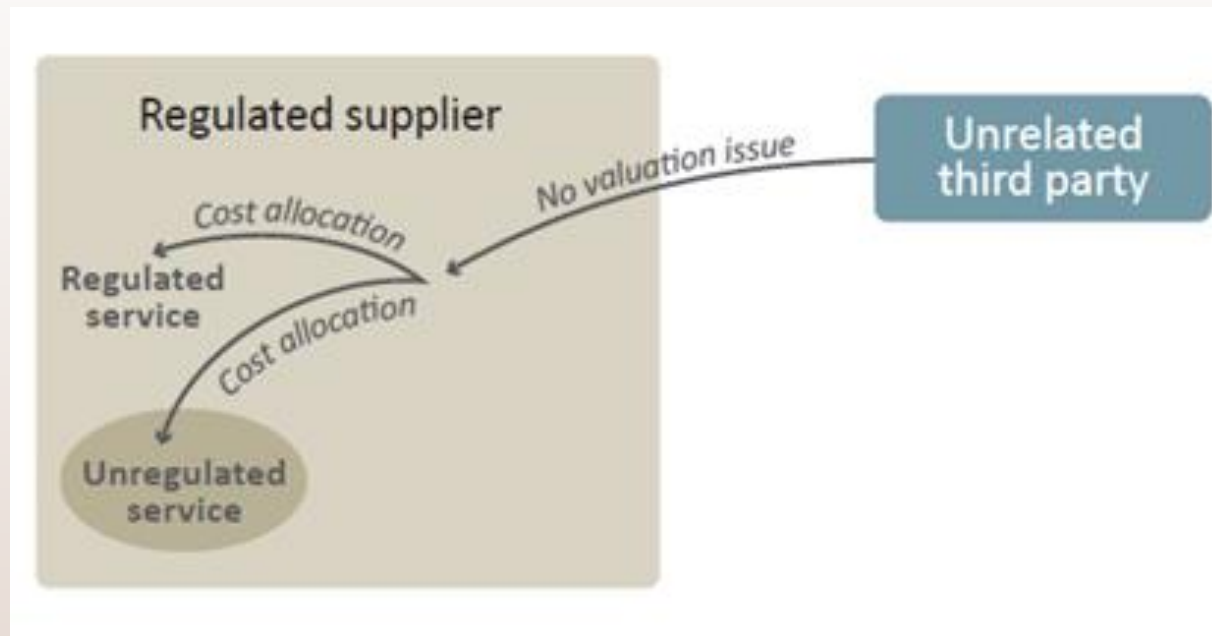


Testing the market (2)

- All related party transactions must meet the arm's-length valuation rule
- Examples of related party transactions identified to us that may be part of related party transactions, depending on whether paragraphs (a) or (b) of the “related party” definition apply, include:
 - Shared service costs
 - Technologies e.g batteries and fast chargers
 - Using common use sites or assets
(see later questions)



No related party (1)



No related party (2)

Facts

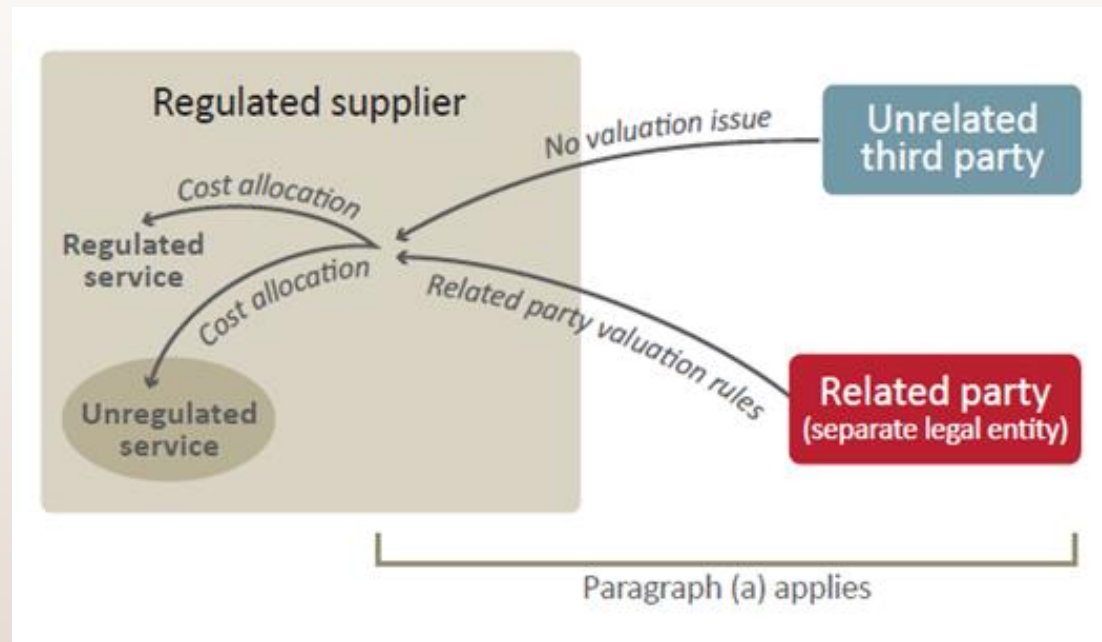
- All costs incurred from external third parties
- All costs directly attributable to regulated service

Key features

- No “related party” of regulated service
- No valuation issue on third party costs (meets arm’s-length valuation rule)
- No cost allocation applies (no cost directly attributable to unregulated service and no cost needs to be allocated between regulated service and unregulated services)



Related party paragraph (a) (1)



Related party paragraph (a) (2)

Facts

- One related party (separate legal entity) supplying regulated supplier
- Some costs from external third parties
- Costs apply to regulated service and unregulated services



Related party paragraph (a) (3)

Key features

- No valuation issue on third party costs (meets arm's-length valuation rule)
- Valuation of charges from related party (required to meet arm's-length valuation rule)
- Costs directly attributable to regulated service (allocated under cost allocation rules to regulated service)
- Costs not directly attributable to regulated service or unregulated service (cost allocation used to allocate between regulated and unregulated services)



Related party paragraph (b) (1)

Interpreting the definition of “related party” – paragraph (b)

- “...ways in which costs are charged to the regulated service, including charges made to the regulated service from an unregulated part of the entity” (reasons paper paragraph 4.68)
- Could the “part” be considered a severable business – distinguish:
 - a business that sells to the regulated service and to external customers
 - a regulated service that sells some services to external customers
(reasons paper paragraphs 4.81 to 4.84)



Related party paragraph (b) (2)

Interpreting the definition of “related party” – paragraph (b) (continued)

- Indicative factors for a “part”:
 - Track record as an identified business unit
 - Management and operating structure potentially capable of operating separately
 - Relative scale of external sales v internal sales
 - Business focus on external sales



Related party paragraph (b) (3)

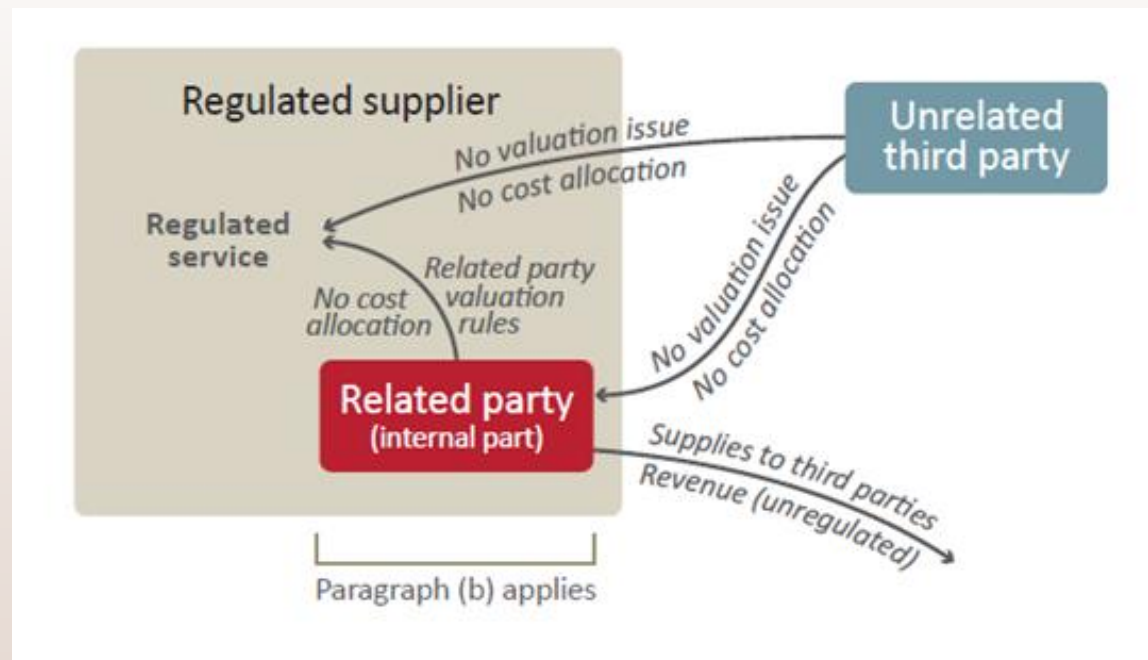
Interpreting the definition of “related party” – paragraph (b) (continued)

- Indicative factors of *not* a “part”:
 - Activity is associated closely with the regulated service
 - No established potentially separable management and operating structure
 - De minimis level of external sales v internal sales

(see further example in later questions)



Related party paragraph (b) and no cost allocation (1)



Related party paragraph (b) and no cost allocation (2)

Facts

- An *internal part of the regulated supplier* supplies to regulated service and sells assets, goods or services externally
- Internal part has management and operational features of a business capable of standing alone
- Some costs incurred directly from external third parties
- Some costs incurred from external third parties through internal related party
- All costs directly incurred from third parties directly attributable to regulated service
- All charges from internal related party directly attributable to regulated service



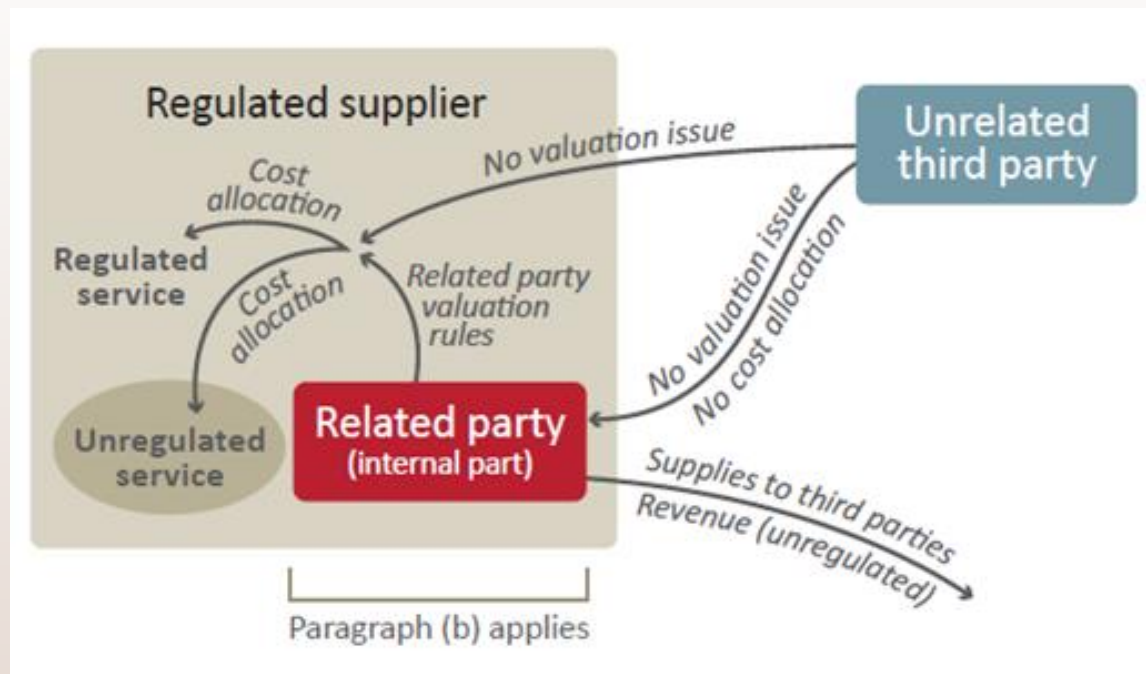
Related party paragraph (b) and no cost allocation (3)

Key features

- No valuation issue on third party costs when passed directly to regulated service at cost with no additional margin (deemed to meet arm's-length valuation)
- Valuation of charges from internal related party (required to meet arm's-length valuation rule)
- No cost allocation on charges from unrelated third party directly to regulated service
- No cost allocation applies on charges from internal related party to regulated service
- No cost allocation or related party valuation rules to charges from unrelated third party to internal related party



Related party paragraph (b) and cost allocation (1)



Related party paragraph (b) and cost allocation (2)

Facts

- Internal part of regulated supplier supplies to regulated service and sells assets, goods or services externally
- Internal part of regulated supplier has management and operational features of a business capable of standing alone
- Some costs incurred by regulated service directly from external third parties
- Some costs incurred from external third parties through internal related party
- Costs apply to regulated service and unregulated services



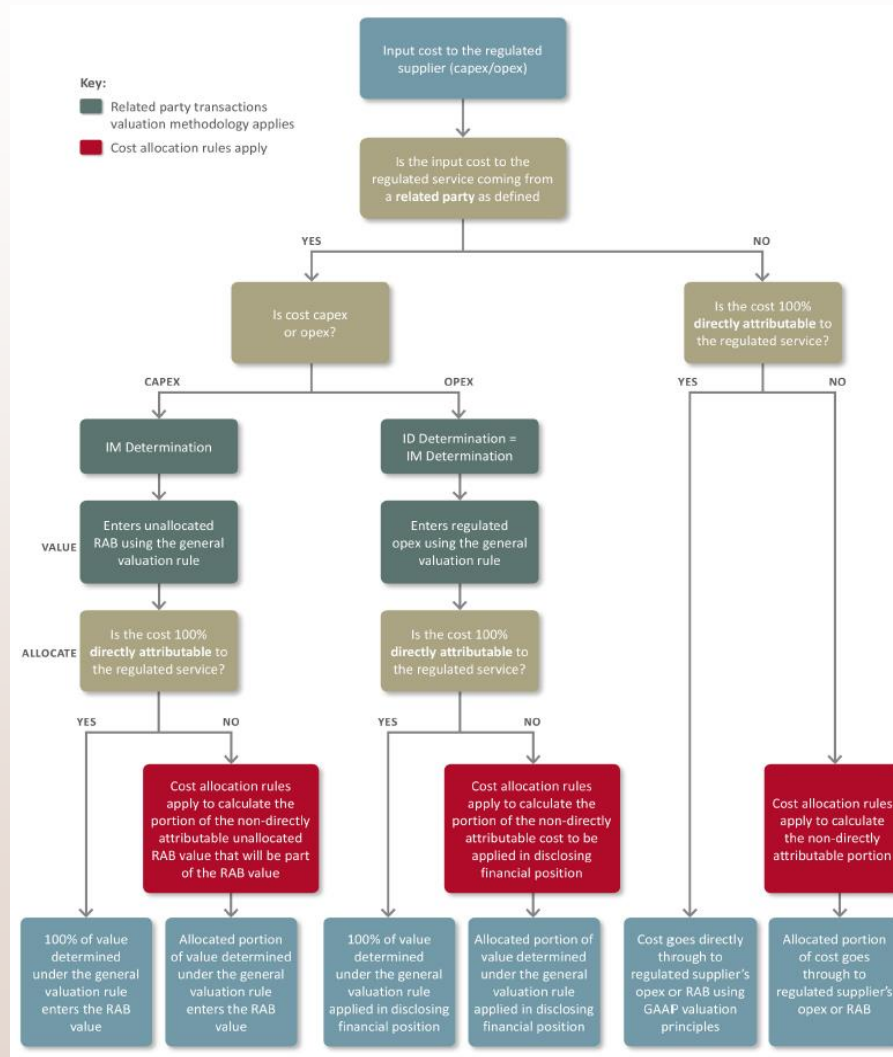
Related party paragraph (b) and cost allocation (3)

Key features

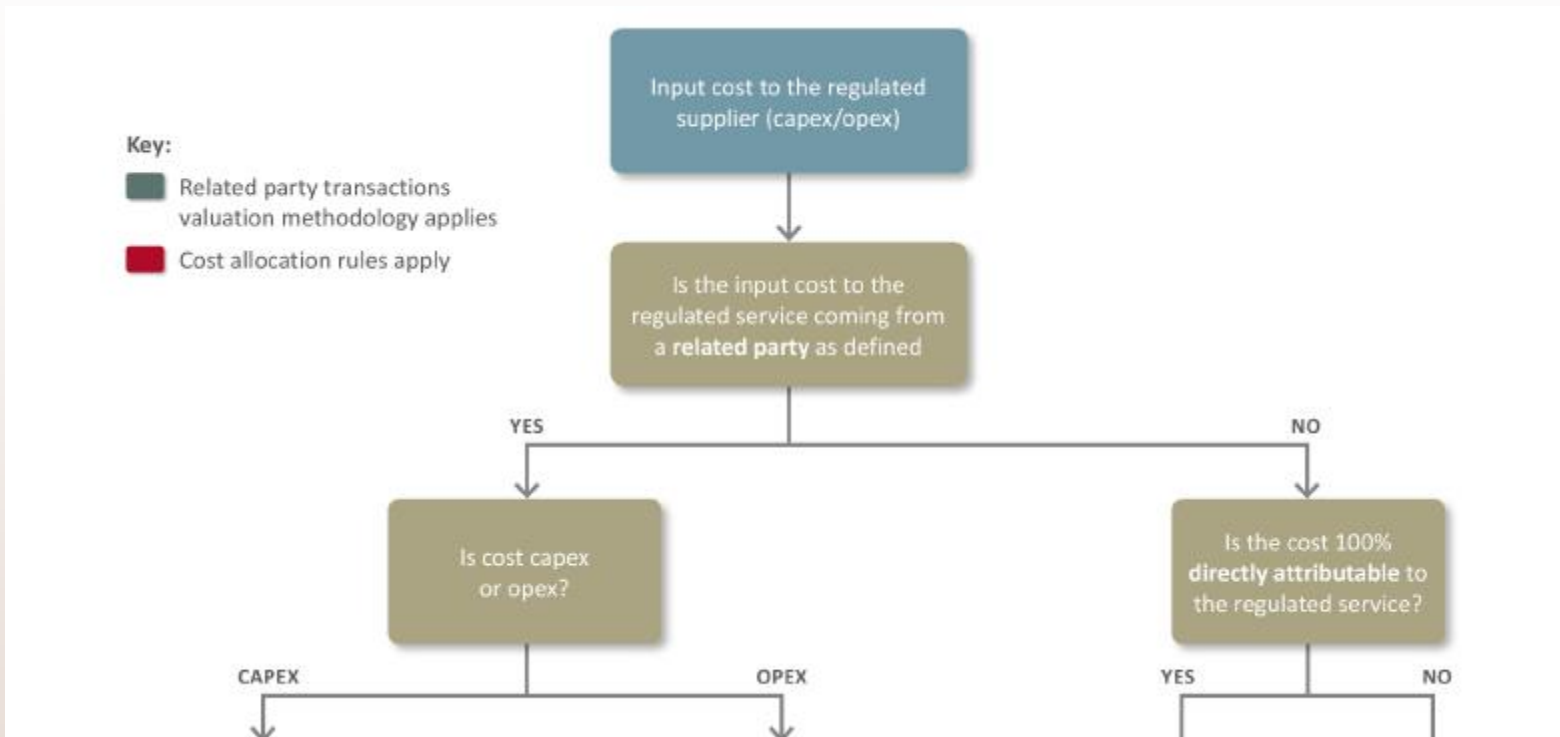
- No valuation issue on third party costs direct to regulated service (meets arm's-length test, as no related party on this)
- Valuation of charges from internal related party (required to meet arm's-length valuation rule)
- Costs directly attributable to regulated service (allocated under cost allocation rules to regulated service)
- Costs not directly attributable to regulated service or unregulated service (cost allocation used to allocate between regulated and unregulated services)
- No cost allocation or related party valuation rules to charges from unrelated third party to internal related party



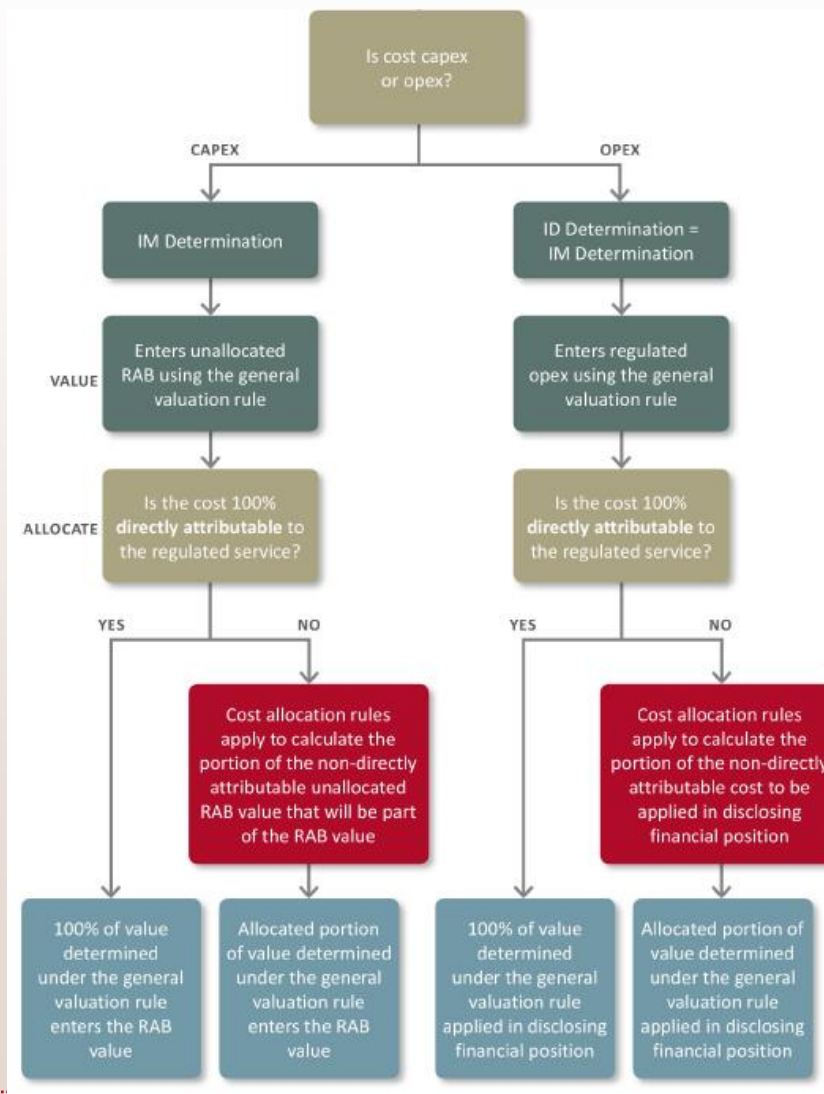
Related party transactions and cost allocation (1)



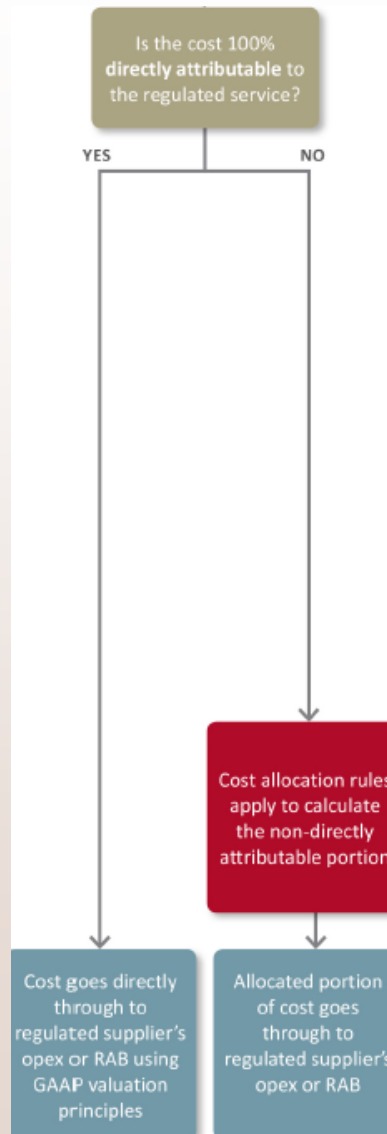
Related party transactions and cost allocation (2)



Related party transactions and cost allocation (3)



Related party transactions and cost allocation (4)



Questions (1)

Examples of de minimis disclosure thresholds in practice

- How the consolidation option works for the application of the de minimis thresholds and disclosure requirements:
 - If the related “paragraph (a)” contracting business is consolidated into the regulated supplier at cost, do we apply the thresholds to the reporting entity in terms of establishing what disclosure obligations apply?



Questions (2)

Examples of de minimis disclosure thresholds in practice (continued)

- Regulated business that may temporarily exceed de minimis thresholds – our response will depend on the facts, for example, see disclosure year 2019 ID exemption:
 - A regulated supplier that usually meets a de minimis threshold for limited disclosure purchases an asset from another regulated supplier which causes capex to exceed the \$20 million threshold on a one-off basis
 - <http://www.comcom.govt.nz/regulated-industries/electricity/information-disclosure-requirements-for-distributors/exemptions-to-information-disclosure-requirements/exemptions-to-electricity-distribution-information-disclosure-requirements/>



Questions (3)

Testing the market

- Discuss what testing the market could look like:
 - Demonstrate that the regulated supplier is not charging any more than what the market costs to do work
 - Some examples of what a regulated supplier could choose to meet the arm's-length valuation rule:
 - Opening tendering process
 - Comparable pricing
 - Independent market evaluation
- Timing of testing the market:
 - Will the regulated supplier need to test the market annually?



Questions (4)

Materiality example

- “What is the Commission’s view on materiality? If 90% of the transactions by value can be assessed as fully arms-length, what is the Commission’s view about the last 10%?”
 - Does the Commission agree that the last 10% is a cost-benefit exercise with likely little if any additional benefit for the additional compliance cost?
 - If the Commission agrees there is a materiality argument, what % of non-complying transactions by value would the Commission be comfortable with?



Questions (5)

Common use sites

- Discuss the treatment of common use sites from which both the regulated supplier and a related party operate
 - Whether the related party is a stand alone legal entity or an operating division of the regulated supplier

Shared services costs

- Discuss the treatment of shared services costs when the regulated service is part of a wider group



Questions (6)

Assets owned and rented by related parties

- Discuss the ownership of technologies such as batteries and fast chargers etc. that are held by associate businesses but are rented to the regulated service to provide some network services



Questions (7)

Asset allocation example

- Consider an example of an asset being shared between the regulated supplier and unregulated services, including the impacts on additions, disposals and depreciation:
 - Truck worth \$100,000 spends 20% of the year on third party work, do we “dispose” of \$20,000 of asset value from the RAB?
 - In the following year, if we do solely regulated service work, would bringing the truck 100% back into the books be via a new commissioned asset (i.e. \$20,000 less depreciation)?
 - See RAB roll forward rule for conversion of unallocated RAB roll forward to allocated closing RAB value (IM clause 2.2.4)



Questions (8)

Related party paragraph (b) in practice

- The regulated supplier does not have a separate company related party as defined under paragraph (a) of the “related party” definition
 - The internal business unit does not fall under paragraph (b) of the definition, namely “any part of the regulated supplier that does not supply regulated services”:
 - The internal contracting business unit does occasional work for third parties, but *none* of the features described in paragraph 4.83 (of the reasons paper) apply
- (continued next page)



Questions (9)

Related party paragraph (b) in practice (continued)

- Internal part of the regulated supplier has *not* been operating as a separate business unit
- Unregulated supplies from the internal part to external customers *do not* exceed the unregulated supplies to the regulated service
- Unregulated service *does not have* management structure, sales and support structure that seems to be capable of being separate from the regulated supplier
- Conclude whether this is a “part” of the regulated supplier for the purposes of paragraph (b)



Questions (10)

Forecast opex for heat map

- Discuss requirements associated with forecast opex projects for the 10 largest opex projects and their effects on network constraints if opex is not delivered as a “project” (ID clauses 2.3.13 (1) & 2.3.13(3) and related clauses 2.3.15 & 2.3.16):
 - opex is not generally undertaken as projects, including office-based network operations and business support
 - opex largely reflects the regulated supplier’s employee costs (60%+ of total opex in disclosures can be non network)
 - network opex is reactive or planned maintenance which may be delivered as ongoing programmes of work such as fault response or vegetation management



Opportunity for discussion



References (1)

Reasons paper

- *Input methodologies review – related party transactions: Final decision and determinations guidance*, Commerce Commission, 21 December 2017

Input methodologies - commissioned assets

- *Electricity distribution services input methodologies amendments determination 2017* [2017] NZCC 30, 21 December 2017; clauses 2.2.11(5) & (6), 5.3.11(7) & (8)
- *Gas distribution services input methodologies amendments determination 2017* [2017] NZCC 31, 21 December 2017; clauses 2.2.11(5) & (6), 5.3.11(7) & (8)

(continued)



References (2)

- *Gas transmission services input methodologies amendments determination 2017* [2017] NZCC 30, 21 December 2017; clauses 2.2.11(5) & (6), 5.3.11(7) & (8)

Information disclosure requirements - EDBs

- *Electricity distribution information disclosure amendments determination 2017* [2017] NZCC 33, 21 December 2017; related party transactions, clauses 2.3.6 to 2.3.16; assurance reports, clauses 2.8.1(1)(d) & (2); independent report, clauses 2.8.2 to 2.8.5

(continued)



References (3)

Information disclosure requirements - GDBs

- *Gas distribution services input methodologies amendments determination 2017* [2017] NZCC 34, 21 December 2017; related party transactions, clauses 2.3.6 to 2.3.16; assurance reports, clause 2.8.1(1)(d) & (2); independent report, clauses 2.8.2 to 2.8.5

Information disclosure requirements - GTB

- *Gas transmission services input methodologies amendments determination 2017* [2017] NZCC 35, 21 December 2017; related party transactions, clauses 2.3.6 to 2.3.16; assurance reports, clause 2.8.1(1)(d) & (2); independent report, clauses 2.8.2 to 2.8.5



References (4)

Website link to related party transactions input methodology papers (copy to your browser)

<http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/related-party-transactions-provisions/>



Contact us

If you cannot resolve issues with the new rules between you and your auditor or advisors, please contact:

- Related party transactions ID requirements:
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- ID compliance requirements generally:
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- Related party transactions ID audit assurance report or the independent report: grant.weston@comcom.govt.nz

