

## **Input methodologies review draft decisions**

### **Topic paper 7: Related party transactions**

**Date of publication:** 16 June 2016

## Associated documents

Publication date	Reference	Title
16 June 2016	978-1-869455-08-8	Input methodologies review draft decisions: Summary paper
16 June 2016	978-1-869455-09-5	Input methodologies review draft decisions: Introduction and process paper
16 June 2016	978-1-869455-10-1	Input methodologies review draft decisions: Framework for the IM review
16 June 2016	978-1-869455-11-8	Input methodologies review draft decisions: Topic paper 1 – Form of control and RAB indexation for EDBs, GPBs and Transpower
16 June 2016	978-1-869455-18-7	Input methodologies review draft decisions: Topic paper 2 – CPP requirements
16 June 2016	978-1-869455-12-5	Input methodologies review draft decisions: Topic paper 3 – The future impact of emerging technologies in the energy sector
16 June 2016	978-1-869455-13-2	Input methodologies review draft decisions: Topic paper 4 – Cost of capital issues
16 June 2016	978-1-869455-14-9	Input methodologies review draft decisions: Topic paper 5 – Airports profitability assessment
16 June 2016	978-1-869455-15-6	Input methodologies review draft decisions: Topic paper 6 – WACC percentile for airports
22 June 2016 (expected)	978-1-869455-16-3	Input methodologies review draft decisions: Report on the IM review
22 June 2016 (expected)	1178-2560	Draft amendments to <i>Electricity Distribution Services Input Methodologies Determination 2012</i> [2012] NZCC 26
22 June 2016 (expected)	1178-2560	Draft amendments to <i>Gas Distribution Services Input Methodologies Determination 2012</i> [2012] NZCC 27
22 June 2016 (expected)	1178-2560	Draft amendments to <i>Gas Transmission Services Input Methodologies Determination 2012</i> [2012] NZCC 28
22 June 2016 (expected)	1178-2560	Draft amendments to <i>Commerce Act (Specified Airport Services Input Methodologies) Determination 2010</i> (Decision 709, 22 December 2010)
22 June 2016 (expected)	1178-2560	Draft amendments to <i>Transpower Input Methodologies Determination 2012</i> [2012] NZCC 17

Commerce Commission  
Wellington, New Zealand

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## Executive summary

### Purpose of this paper

- X1. The purpose of this paper is to explain in relation to the related party transactions topic:
  - X1.1. the issues we have identified to date within this topic area;
  - X1.2. that, although we consider that the identified issues may be symptomatic of a broader problem, we have not yet identified this broader problem;
  - X1.3. our proposed approach for further exploring whether the identified issues amount to a broader problem with the related party transactions regime and considering what the best solution to any such problem might be; and
  - X1.4. how we have taken stakeholders' submissions into account in considering the points above.
- X2. The issues described in this paper and our proposed approach to addressing them apply to electricity distribution businesses (**EDBs**), gas distribution businesses (**GDBs**) and gas transmission businesses (**GTBs**).

### Overview of the related party transactions topic

- X3. The result of our review of the related party transaction provisions in the input methodologies (**IMs**) so far is that the policy intent behind them remains appropriate. That policy intent is to ensure that related party arrangements cannot be manipulated by regulated suppliers in a way that allows them to extract excessive profits.
- X4. We have, however, identified a number of issues (outlined in Chapter 2) that suggest that there might be opportunities to improve the effectiveness of the related party transactions provisions – across the IMs and information disclosure (**ID**) – in achieving that policy intent.
- X5. The issues describe a range of symptoms that indicate that the related party rules may not be functioning as well as they could on a practical level. We have concerns that they are also indicative of a broader problem. We do not yet know the precise nature of this broader problem.
- X6. Based on the information currently available, we consider the potential benefits of making IM amendments now, while we do not have a complete problem definition, do not outweigh the likely benefits from taking more time.
- X7. Our proposed approach to addressing the issues we have identified is therefore to:
  - X7.1 not propose any changes to the related party transactions provisions in the IMs at this stage of the IM review process; and

- X7.2 instead further explore whether the identified issues amount to a broader problem with the related party transactions regime and consider what the best solution to any such problem might be. In doing so, we will assess the extent to which the related party transaction provisions in both the IM and ID determinations for the EDB, GDB and GTB sectors achieve the policy intent of the related party transaction regime.

*Timeframes for our further work on the related party transactions regime*

- X8. The further work we propose to do on the related party transactions regime would be carried out within the current IM review.<sup>1</sup>
- X9. If our further work confirms a problem with the related party transactions provisions requiring changes to the IMs, this is likely to extend beyond the December 2016 timeframe for the rest of the review. On the other hand, if our further work does not identify a problem requiring changes to the IMs, we may be able to reach draft and final decisions on the related party IMs by December 2016.
- X10. We aim to update stakeholders in early September 2016 on our timing for draft and final decisions in respect of the related party transactions IMs.<sup>2</sup>

**Invitation to make submissions**

- X11. We invite submissions on this paper by **5pm on 28 July 2016**. We will then invite cross submissions by **5pm on 11 August 2016**.
- X12. Please address submissions and cross submissions to:
- Keston Ruxton  
Manager, Input Methodologies Review  
Regulation Branch  
[im.review@comcom.govt.nz](mailto:im.review@comcom.govt.nz)
- X13. Please clearly indicate within your submission which aspects of this paper it relates to.

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<sup>1</sup> Any changes to the ID requirements would be consulted on and made under s 52Q of the Act, rather than under s 52Y.

<sup>2</sup> As discussed in the Introduction and process paper, we anticipate providing a general process update at this time.

## Chapter 1: Introduction

### Purpose of this paper

1. The purpose of this paper is to explain in relation to the related party transactions topic:
  - 1.1 the issues we have identified within this topic area;
  - 1.2 that, although we consider that the identified issues may be symptomatic of a broader problem, we have not yet identified this broader problem;
  - 1.3 our proposed approach for further exploring whether the identified issues amount to a broader problem with the related party transactions regime and considering what the best solution to any such problem might be; and
  - 1.4 how we have taken stakeholders' submissions into account in considering the points above.

### Where this paper fits in to our package of draft decisions papers

2. This topic paper forms part of our package of draft decision papers on the input methodologies (**IM**) review. For an overview of the package of papers and an explanation of how they fit together, see the Introduction and process paper published as part of our draft decision package.<sup>3</sup>
3. While this paper does not propose any changes to the IMs, we note that the framework we have applied in reaching our draft decisions on the IM review is set out in a separate paper, published alongside this paper. The framework paper explains that we have only proposed changing the current IMs where this appears likely to:<sup>4</sup>
  - 3.1 promote the Part 4 purpose in s 52A of the Commerce Act 1986 (**Act**) more effectively;
  - 3.2 promote the IM purpose in s 52R more effectively (without detrimentally affecting the promotion of the s 52A purpose); or
  - 3.3 significantly reduce compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s 52A purpose).
4. The framework paper also describes key economic principles that can provide guidance as to how we might best promote the Part 4 purpose.

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<sup>3</sup> Commerce Commission "Input methodologies review draft decisions: Introduction and process paper" (16 June 2016).

<sup>4</sup> Commerce Commission "Input methodologies review draft decisions: Framework for the IM review" (16 June 2016).

### Structure of this paper

5. Two chapters follow this introductory chapter. Chapter 2, “Issues identified with related party transaction rules”, provides a description of three issues or potential issues we have identified in the related party transactions topic area.
6. Chapter 3, “The proposed approach to addressing issues with the related party transaction rules”, provides an explanation of proposed approach for further exploring whether the identified issues amount to a broader problem with the related party transactions regime and considering what the best solution to any such problem might be.
7. In describing the issues and our proposed approach to addressing the issues, we explain how we have taken stakeholders’ submissions into account and how they have helped to shape our proposed approach to addressing the issues we have identified in our review so far.

### Introduction to the related party transactions topic

8. This topic stems from submissions on our problem definition paper,<sup>5</sup> the IM forum discussions and our analysis of symptoms that indicate a potential problem with the related party transactions regime.
9. In our June 2015 problem definition paper, we suggested four areas that might particularly benefit from a review for unwarranted complexity and compliance costs: related party transactions, regulatory taxation, cost allocation, and cost definitions. Related party transactions generated the most attention out of those four areas in submissions.
10. Around one third of EDBs’ operating expenditure (**opex**) and capital expenditure (**capex**) is made under a related party transaction.
11. Our preliminary analysis of available information and data indicated that a large amount of information about related party transactions is not visible to us under the current rules for related party transactions (which sit across the IMs and information disclosure (**ID**) requirements. Given the scale of related party transactions, we need to better understand whether there is a larger problem with how the related party transaction rules operate to limit suppliers gaining excessive profits.
12. As a result of the sector interest and our own preliminary analysis, we have classified this topic as a key topic for the IM review in its own right.

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<sup>5</sup> Commerce Commission “Input methodologies review: Invitation to contribute to problem definition” (16 June 2015).



### Who is this paper relevant to?

13. The issues described in this paper and our proposed approach to addressing them apply to regulated suppliers under the IM determinations for electricity distribution businesses (**EDB**), gas distribution businesses, (**GDB**) and gas transmission businesses (**GTB**).
14. This paper may also be of interest to:
  - 14.1 Entities involved in (or planning to be involved in) related party transactions with regulated suppliers under the EDB, GDB, and GTB IM determinations;
  - 14.2 Other gas and electricity firms, such as generator-retailers; and
  - 14.3 Consumers of electricity lines services and gas pipeline services.

### Invitation to make submissions

15. We invite submissions on this paper by **5pm on 28 July 2016**. We then invite cross submissions by **5pm on 11 August 2016**.
16. Please indicate clearly in your submission that it is a submission on this topic paper, and which aspects of this paper your submission relates to.
17. Please address submissions and cross submissions to:
 

Keston Ruxton  
 Manager, Input Methodologies Review  
 Regulation Branch  
[im.review@comcom.govt.nz](mailto:im.review@comcom.govt.nz)
18. The Introduction and process paper contains further details about the submissions process. This includes:<sup>6</sup>
  - 18.1 explaining that material provided outside of the indicated timeframes without an extension might not be considered in reaching our final decisions;
  - 18.2 providing guidance on requesting an extension to the submissions timeframes;
  - 18.3 noting that we prefer submissions on our draft decisions in a file format suitable for word processing, rather than the PDF file format; and
  - 18.4 providing guidance on making confidential submissions.

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<sup>6</sup> Commerce Commission “Input methodologies review draft decisions: Introduction and process paper” (16 June 2016), Chapter 5.

## Chapter 2: Issues identified with the related party transaction regime

### Purpose of this chapter

19. The purpose of this chapter is to:
  - 19.1 explain issues we have identified with the related party transactions regime in our review of the IMs; and
  - 19.2 explain that we have not yet reached a view on whether these issues amount to a defined problem.
20. Our proposed approach to further exploring whether the identified issues amount to a broader problem with the related party transactions regime, and what the best solution to any such problem might be, is described in Chapter 3.

### There may be opportunities to improve the effectiveness of the related party transactions provisions in the IMs and ID

21. The results of our review of the related party transaction provisions in the IMs so far indicate that the policy intent behind them remains appropriate. That policy intent is to ensure that related party arrangements cannot be manipulated by regulated suppliers in a way that allows them to extract excessive profits.
22. We have, however, identified a number of issues (outlined below) that suggest that there might be opportunities to improve the effectiveness of the related party transactions provisions (across the IMs and ID) in achieving that policy intent.
23. In reaching our current views, we have considered a number of submissions on the complexity and compliance cost aspects of the related party transaction provisions in the IMs. These concerns about complexity and compliance costs are reflected in the issues we have identified.
24. The issues we have identified describe a range of symptoms that indicate that the related party rules may not be functioning as well as they could on a practical level. We have concerns that they are also indicative of a broader problem. We do not yet know the precise nature of this broader problem.
25. Compounding our concerns is that:
  - 25.1 We have observed issues with suppliers' compliance with the related party transaction rules across the IMs and ID. These are concerning in their own right. However, the compliance issues also make it harder to understand the bigger problem, as, for example, it means the data and information we have been provided under information disclosures is in some cases incomplete or inaccurate.
  - 25.2 Related party transactions accounted for a third of operating expenditure and one quarter of capital expenditure declared by EDBs, GDBs and GTBs under ID in 2015.

- 25.3 The value of these transactions is high, both in relative terms and in absolute terms (\$155 million in opex and \$179 million in capex). These values have also increased over time.<sup>7</sup>
- 25.4 We have limited visibility of related party transactions on the non-regulated entities' side. Combined with regulated suppliers' level of control over related party transactions, we are concerned with the risk that suppliers may be able to generate excessive profits under the current rules.

### **Issues and potential issues with the related party transaction provisions**

26. Based on our review of the related party provisions in the IMs so far, we have identified three issues:
- 26.1 **Issue 1:** There appear to be interpretation and implementation issues with the related party transaction provisions.
- 26.2 **Issue 2:** There may be opportunities to better align or explain the rules between related party operating expenditure rules and related party capital expenditure rules.
- 26.3 **Issue 3:** Related party transaction values are proportionately significant for regulated entities and are increasing in overall value. We are concerned that suppliers are able to generate excessive profits under the current rules.

### *Challenges in dealing with the identified issues*

27. The most significant challenges with this topic area are:
- 27.1 It cuts across IMs, ID, and compliance with price-quality determinations – we therefore need to consider the related party transaction rules across all of the relevant aspects of the regulatory regime for EDBs, GDBs and GTBs.
- 27.2 We do not know enough about all of the current applicable types of transactions (including their structures) and need to better understand the relationship between these and the trends we are observing in related party transactions. We need more transaction data and more information on typical transaction arrangements before we can reach a well-informed view on what, if any, changes to the related party transactions regime might be beneficial.
28. We would like to further engage with industry in exploring whether the identified issues amount to a broader problem with the related party transactions regime and considering what the best solution to any such problem might be. We want to do this

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<sup>7</sup> Total related party opex for EDBs, GDBs and GTBs was \$70 million in 2012, \$115 million in 2013 and \$137 million in 2014. Total related party capex for the sector was \$128 million in 2012, \$143 million in 2013 and \$138 million in 2014.

looking at the related party transactions regime holistically – ie, looking at both the relevant IMs and ID requirements.

**We have identified one specific problem regarding the related party transactions information requirements for CPP proposals**

29. We have identified one specific problem in relation to the information requirements on related party transactions required for a customised price-quality path (**CPP**) proposal. That problem is more relevant to the CPP requirements topic, and so is discussed, along with our proposed solution to that problem, in Topic paper 2: CPP requirements.<sup>8</sup>

**Explanation of each issue we have identified**

30. This section outlines the three issues we have identified regarding the related party transactions provisions from our review so far.

*Issue 1: There appear to be interpretation and implementation issues with the related party transaction provisions*

31. In our review of the related party provisions of the IMs so far, we have identified interpretation and implementation issues with the related party valuation options across both the ID and IM determinations.
32. Specific points raised by submissions to the IM review include:
- 32.1 Interpretation of the term, “directly attributable costs” in both the IM and ID rules;
  - 32.2 The appropriateness of director certification as a valuation option; and
  - 32.3 The interpretation and application of the “17.2% margin” option in the ID rules.
33. Changes to the IMs alone may not be the best way to address these issues and there may be other solutions (such as guidance/education or compliance activity) that would be more appropriate.

“Directly attributable costs”

34. The related party transactions rules in the EDB, GTB and GPB IMs provide a valuation option for capital expenditure that allows a supplier to use the “directly attributable cost” to a “group” to which the supplier and a related party belong under GAAP.
35. Under this option, intra-group charges used to determine direct costs to the related party should be attributed in accordance with the cost allocation IM, or as would

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<sup>8</sup> Commerce Commission “Input methodologies review draft decisions: Topic paper 2 – CPP requirements” (16 June 2016).

otherwise be disclosed by the supplier under an information disclosure determination.

36. We received submissions that the term “directly attributable costs” is defined too narrowly<sup>9</sup> and is not appropriate unless “not directly attributable cost” is also included in the related party rules (as it is in the cost allocation IM).<sup>10</sup> The term also appears in different contexts in the IMs and in the ID, which makes it difficult to interpret.
37. We agree that the current uses of the term “directly attributable costs” in the related party provisions in the current IM and ID determinations can make the rules difficult to interpret.

#### Director certification option

38. When no other valuation options are available, the related party rules in the IMs allow a supplier to use the price paid for an asset by a related party if at least two directors of the supplier provide written certification that the price of the assets reflect what would have been received in an arm’s-length transaction.<sup>11</sup> This is commonly referred to as the “director certification” option.
39. We received submissions that the appropriateness of the director certification option is an issue:
- 39.1 The director certification option can only be used where none of the other valuation options are available. PwC submitted that this is problematic because in some cases, other options may be technically available but would not lead to sensible outcomes as they would restrict the value of related party transactions to less than those that would be established on an arms’-length basis.<sup>12</sup>
- 39.2 Alpine Energy submitted that director certification is not ideal, as it asks directors to delve deeper into operations than directors can be expected to.<sup>13</sup>

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<sup>9</sup> Alpine Energy “Submission to Commerce Commission on input methodologies review: Invitation to contribute to the problem definition” (21 August 2015), paras 18-22.

<sup>10</sup> PwC “Submission to the Commerce Commission on input methodologies review: Invitation to contribute to problem definition (21 August 2015), paras 135-140. In the submission, PwC also raised that using the term in the context of GAAP is problematic because GAAP does not recognise the term.

<sup>11</sup> *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, clause 2.2.11(5)(h); *Gas Distribution Services Input Methodologies Determination 2012* [2012] NZCC 27, clause 2.2.2.11(5)(h); and *Gas Transmission Services Input Methodologies Determination 2012* [2012] NZCC 28, clause 2.2.11(5)(h).

<sup>12</sup> PwC “Submission to the Commerce Commission on input methodologies review: Invitation to contribute to problem definition (21 August 2015), paras 135-140.

<sup>13</sup> Alpine Energy “Submission to Commerce Commission on input methodologies review invitation to contribute to the problem definition” (21 August 2015), para 9.

40. We are also aware (anecdotally) of management and boards of regulated suppliers experiencing issues with obtaining (or being sufficiently comfortable to provide) director certification for the purposes of the related party transaction rules.
41. Although we are not convinced, at this stage, that the director certification option is not achieving the policy intent of the related party rules, we acknowledge the submissions and are interested in receiving evidence about any potential unintended outcomes of the option.

The “17.2% option”

42. Under the ID rules, a supplier can apply a mark-up of up to 17.2% to the directly attributable cost of a related party’s contracting services to maintain or develop the supplier’s network. This is commonly referred to as the “17.2% rule” or the “17.2% margin” option.
43. Alpine Energy submitted that the method used to set the 17.2% threshold for the 17.2% margin option should be reviewed.
44. We note that the valuation option is set in the ID determinations and not in the IM provisions. Nonetheless, we have identified that there are interpretation and/or compliance issues with the 17.2% margin option in ID,<sup>14</sup> arising from some suppliers incorrectly applying the 17.2% margin option to related party capital expenditure.
45. The interpretation issues with the 17.2% margin option, where some suppliers are incorrectly using ID valuation options for capital expenditure (or incorrectly using IM valuation options for related party operating expenditure), suggest that some regulated suppliers may not fully understand the related party provisions across both IM and ID.
46. Issues with suppliers understanding, interpreting and applying the valuation options across ID and IM can potentially lead to compliance issues for suppliers and, in some circumstances, suppliers being able to recover more (or less) from consumers than if a correct valuation option had been used.

*Issue 2: There may be opportunities to better align or explain the rules between related party operating expenditure and capital expenditure rules*

47. The IMs deal with related party capital expenditure, but not related party operating expenditure, which is only addressed in the ID requirements.

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<sup>14</sup> *Electricity Distribution Information Disclosure Determination 2012 [2012] NZCC 22, clause 2.3.6(1)(b); Gas Distribution Information Disclosure Determination 2012 [2012] NZCC 23, clause 2.3.6(2)(b); Gas Transmission Information Disclosure Determination 2012 [2012] NZCC 24, clause 2.3.7(2)(b).*

48. We received submissions that the current design of the related party transaction rules (ie, across the IMs and ID) gives rise to unnecessary confusion and complexity and that the provisions are inconsistent across the various determinations.<sup>15</sup>
49. PwC submitted that improved consistency could be achieved by:<sup>16</sup>
- 49.1 better aligning the sequencing of the valuation options;
  - 49.2 ensuring the terminology is consistent and unambiguous; and
  - 49.3 ensuring the valuation criteria which have substantially the same effect are expressed consistently.
50. We agree that there are opportunities to better align the related party rules between operating expenditure (in ID) and capital expenditure (in the IMs).
51. While these issues could potentially be addressed by amending the IMs now to better align with the ID requirements, we do not consider that to be the best solution. A piecemeal approach to addressing inconsistency by only making changes to the IMs could lead to further change at a later date, when related party rules in ID are reviewed. (It is possible that the related party rules in ID may not be fit for purpose).
52. We consider that better aligning or explaining the rules between related party operating expenditure and capital expenditure is a problem that cannot be fully addressed by considering only the IMs, without also engaging with stakeholders further and looking at the related party regime holistically, in light of more information.
53. We consider that the issue requires a broader perspective beyond reviewing only the IMs to reduce complexity and compliance costs. Whether and how provisions should work between the IMs and ID needs to be considered holistically, with the objective of having a cohesive set of rules for related party transactions that:
- 53.1 achieve the policy intent of the related party transactions regime;
  - 53.2 are easy to understand; and
  - 53.3 can be implemented without unnecessary compliance costs and uncertainty.

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<sup>15</sup> PwC "Submission to the Commerce Commission on input methodologies review: Invitation to contribute to problem definition (21 August 2015), para 130.

<sup>16</sup> PwC "Submission to the Commerce Commission on input methodologies review: Invitation to contribute to problem definition (21 August 2015), para 132.

*Issue 3: Related party transaction values are significant and the overall value is increasing*

54. Related party transaction values are a significant and increasing aspect of some regulated suppliers' expenditures. We are curious as to why this is, and would like to understand this better; for example:
- 54.1 Why has the value of related party transactions been increasing? Is this driven by genuine commercial efficiency or for regulatory reasons?
  - 54.2 What is the impact and magnitude of the observed trends on the long-term benefit to consumers?
  - 54.3 Why do suppliers choose the transaction valuation methods they use?
  - 54.4 Are there policy, interpretation or compliance issues that need to be considered? What is the best response to these issues?
  - 54.5 What are the implications for the related party provisions in the IM and ID determinations? What changes, if any, should we make to the rules?

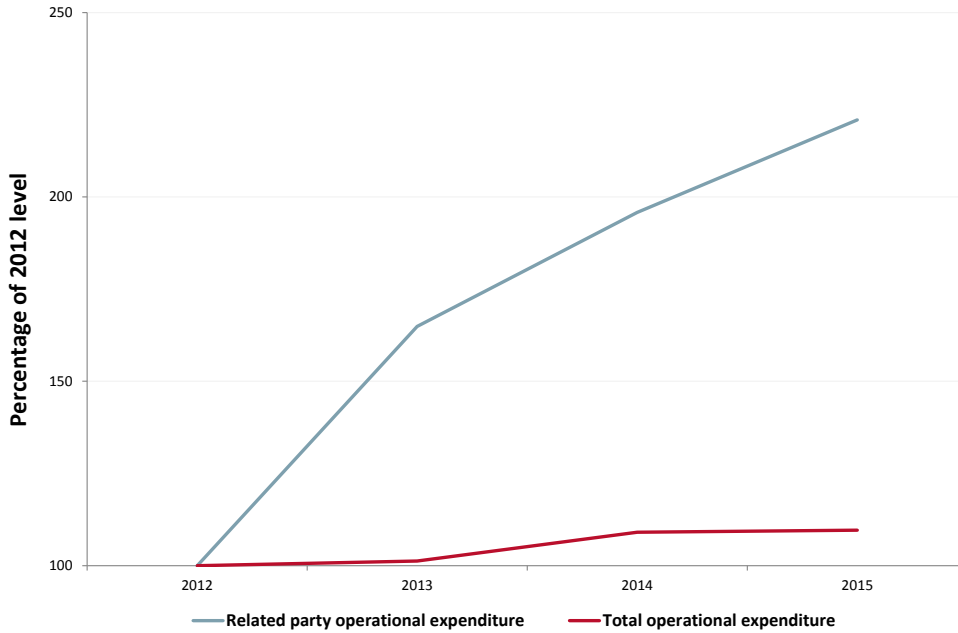
Examples of trends we are interested in

55. We have observed some trends with related party transactions in information disclosures made by regulated suppliers. These trends are of interest to us, as they could be indicative of a bigger problem with the related party rules across both the IMs and ID.
56. We do not know the reasons for these trends. For example, we do not know whether more related party transactions are taking place, or certain valuation options are being chosen because they produce the most efficient outcome. Nor do we know the extent to which the related party rules are influencing suppliers' decisions (ie, if suppliers were choosing particular valuation options or structures primarily to increase profits via an unregulated related party).
57. Examples of the trends we are interested in are:
- 57.1 large increases in related party operating expenditure in absolute terms;
  - 57.2 increased related party operating expenditure as a proportion of total operating expenditure;
  - 57.3 related party transactions appear to feature strongly in the operating expenditure or capital expenditure for some EDBs, GDBs and GTBs and not others; and
  - 57.4 increasing levels of avoided cost of transmission (**ACOT**) payments made by regulated suppliers and some outliers in ACOT pricing.



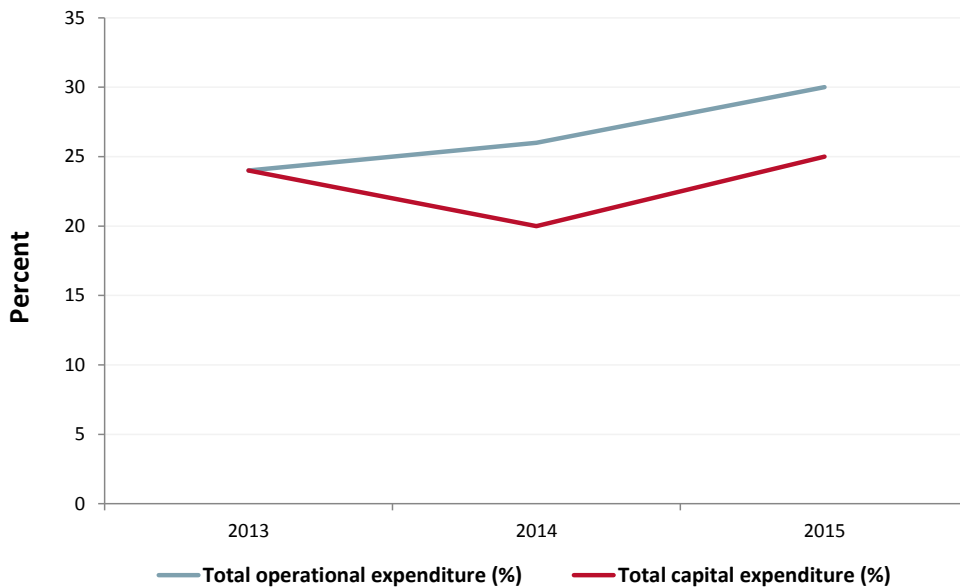
58. Figure 1 shows that between 2012 and 2015, EDBs’ related party operating expenditure has more than doubled, while total operating expenditure for all EDBs has remained relatively stable over the same time period.

**Figure 1: Trend in operational expenditure 2012-2015**  
**Total vs related party for all EDBs**



Source: Commerce Commission analysis of information disclosures made by regulated suppliers

59. Figure 2 shows that related party operating expenditure as a percentage of all EDBs’ total operating expenditure increased steadily from 24% to 30% between 2013 and 2015. Related party capital expenditure as a percentage of total capital expenditure has not experienced a similar upward trend.

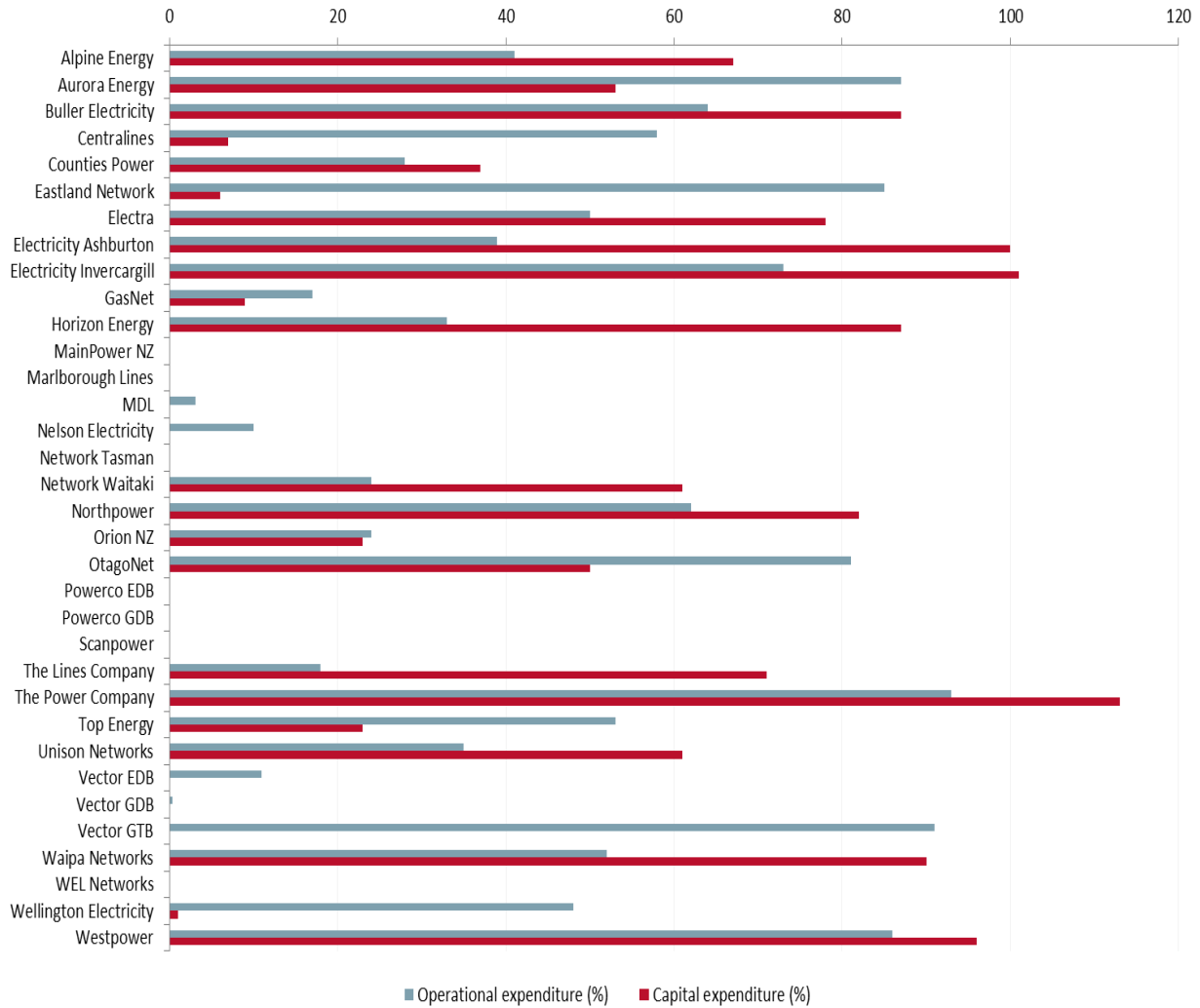
**Figure 2: Proportion of EDBs' total opex and capex from related parties 2013-2015**

Source: Commerce Commission analysis of information disclosures made by regulated suppliers

60. Figure 3 shows that, while some suppliers do not have high levels of related party transactions, related party transactions feature prominently in opex or capex for other suppliers.
61. We were surprised by the levels of related party transactions disclosed by particular suppliers shown in Figure 3 as our understanding was that they have more significant related party transactions than reported. We also note that some suppliers have disclosed more related party capex than their total capex for 2015.<sup>17</sup>

<sup>17</sup> This results in percentage results greater than 100% for Electricity Ashburton, Electricity Invercargill and The Power Company on the graph.

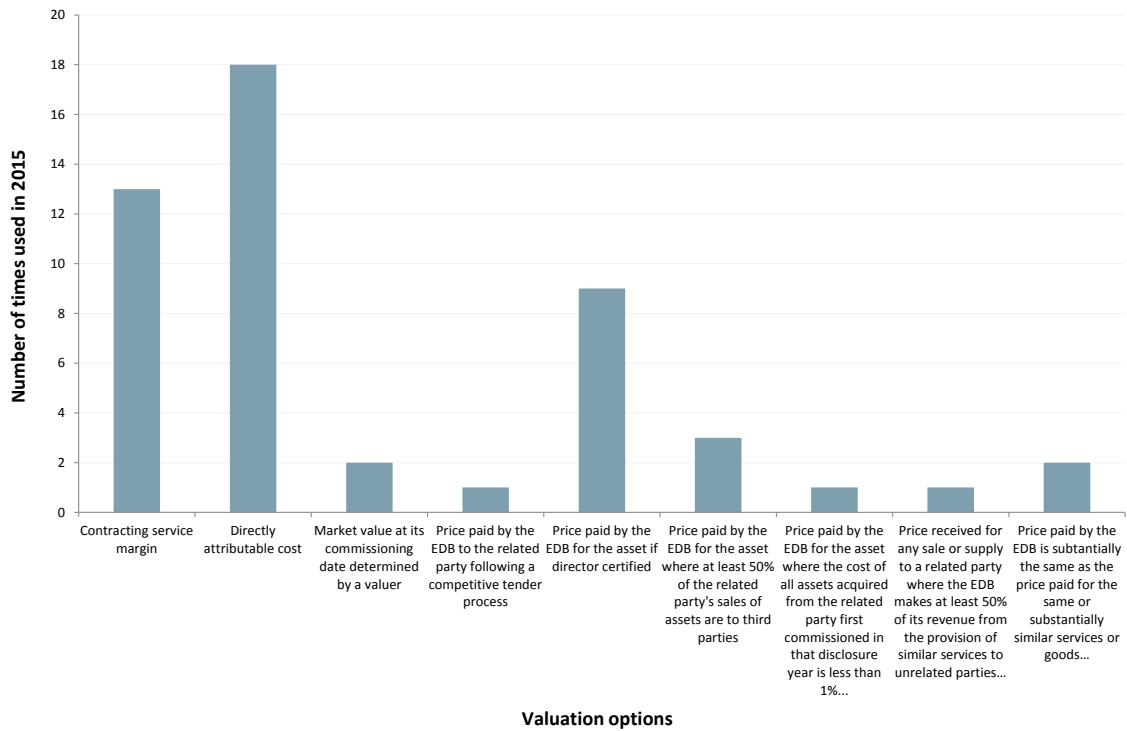
**Figure 3: Percentage of total opex and capex from related parties for each EDB/GPB in 2014/2015**



Source: Commerce Commission analysis of information disclosures made by regulated suppliers

62. Some valuation options are used much more frequently than others. Figure 4 shows the distribution of valuation options used by EDBs for related party capital expenditure in 2015. The second most popular option, the “contracting service margin” option, is being used incorrectly, as it is not a valuation option available for capex in the IMs and is a valuation option only allowed under the ID rules for opex.

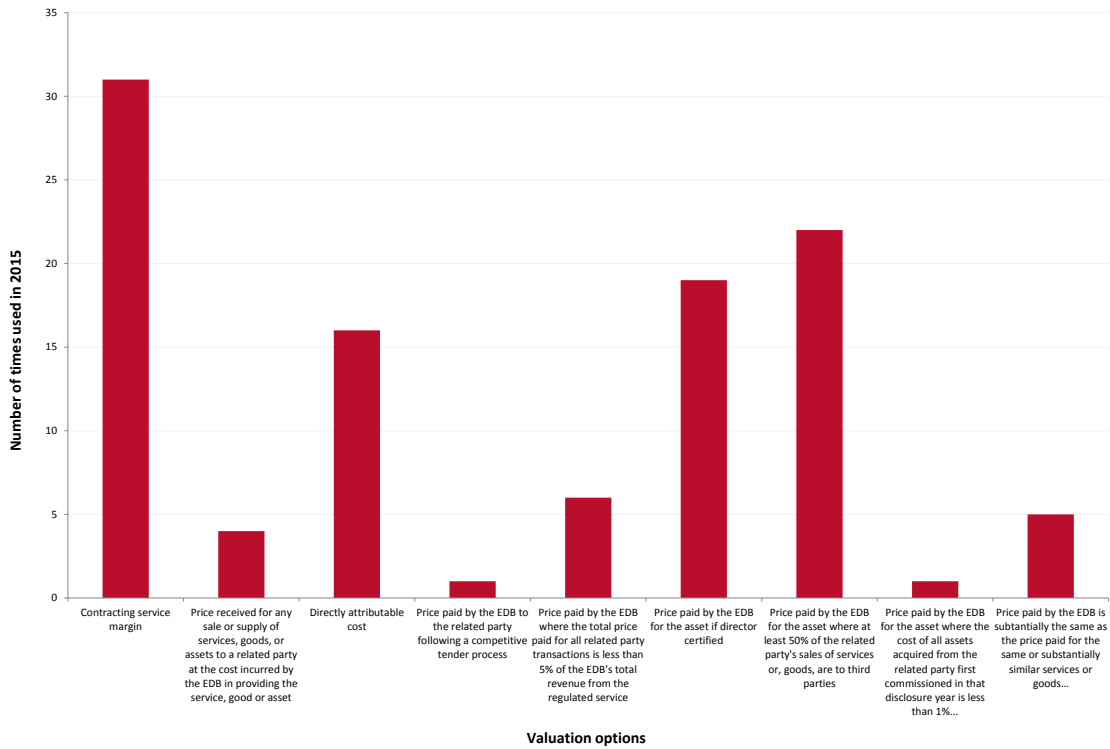
**Figure 4: Related party options used by EDBs for capital expenditure in 2015**



Source: Commerce Commission analysis of information disclosures made by regulated suppliers

63. Figure 5 below shows that the “contracting service margin” option is the most popular valuation option used under the related party ID rules for operating expenditure. We are curious about why this valuation option is preferred by suppliers and what the implications of this are for consumers and suppliers.

**Figure 5: Related party options used by EDBs for operational expenditure in 2015**



Source: Commerce Commission analysis of information disclosures made by regulated suppliers

- 64. In addition to related party transactions identified in information disclosures, we have also observed increasing levels of ACOT payments made by regulated suppliers for distributed generation over the last few years and are aware of some outliers in ACOT pricing for distributed generation.
- 65. ACOT payments have been increasing at a much higher rate than generation over the last four years.

**Table 1: ACOT payments disclosed by EDBs from 2011/2012 to 2014/2015**

	2011/12	2012/13	2013/14	2014/15
<b>ACOT (\$m)</b>	37	57	62	52
<b>Generation (GWh)</b>	(?)	3,100	3,001	3,173

Source: Commerce Commission analysis of information disclosures made by regulated suppliers

- 66. We are also concerned that some of the outliers in ACOT pricing have been incurred in related party transactions. For example, the highest per-kWh ACOT payments made by an EDB are 15 times higher than the lowest ACOT payment made by an EDB. The highest per-kWh ACOT payments are being made in related party transactions.

67. Although what we have observed does raise some flags, an issue is that our data on ACOT payments is not complete. We would particularly welcome submitters' views on this issue, especially on some of our observations where we have noted that additional information would be useful.

## Chapter 3: Proposed approach for addressing the issues identified

### Purpose of this chapter

68. The purpose of this chapter is to explain our proposed approach for further exploring whether the identified issues amount to a broader problem with the related party transactions regime and considering what the best solution to any such problem might be.

### Proposed approach for addressing the issues we have identified with the related party transactions IMs

69. Our proposed approach for addressing the issues we identified with the related party transactions provisions in the IMs is to:

- 69.1 not propose any changes to the related party transactions provisions in the IMs at this stage of the IM review process; and
- 69.2 instead further explore whether the identified issues amount to a broader problem with the related party transactions regime and consider what the best solution to any such problem might be. In doing so, we will assess the extent to which the related party transaction provisions in both the IM and ID determinations for the EDB, GDB and GTB sectors achieve the policy intent of the related party transaction regime. We propose to do this within the current IM review,<sup>18</sup> and will update stakeholders on the timing for our draft and final decisions in September 2016.

### *Reasons for preferring this approach*

70. The key reason for not proposing changes at this stage and instead spending more time on problem definition is that, based on current information, we consider the potential pros of making amendments now are not sufficiently clear to outweigh the potential cons of doing so. The cons are:
- 70.1 amending the IM determinations now may not be the best way to address the implementation and interpretation issues we have identified in our review;
- 70.2 there may be a broader problem that exists with the related party transaction provisions in ID;
- 70.3 we do not consider it appropriate to make changes to the related party transaction provisions of the IM determinations without fully understanding the bigger problem with the related party regime; and

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<sup>18</sup> Any changes to the ID requirements would be consulted on and made under s 52Q of the Act, rather than under s 52Y.

- 70.4 we do not fully understand how changes to the IM determinations would affect suppliers, their related parties or any commercial arrangements or structures they may have under the current rules.
71. We are not confident that any changes we could propose at this stage would address a broader problem of which these issues are symptoms, so the pros are limited.
72. We consider that taking more time to explore any potential problems with the related party transactions regime is useful because:
- 72.1 it will allow us to look at a wider context than the IM determinations and would consider the regime holistically, including the ID determinations and compliance concerns;
- 72.2 it will provide opportunities for us to provide further guidance for stakeholders about the purpose and meaning of the related party options and how to comply with them; and
- 72.3 it will provide greater opportunity for further input from stakeholders to develop and test possible solutions.
73. We have only heard from a small number of stakeholders on related party issues, and given the increasing importance of the related costs involved in setting price-quality paths, we would like to engage with a broader range of stakeholders about the related party transaction valuation rules.
74. In particular, we wish to further engage with stakeholders and get more information and explanations to better understand a range of matters, including (but not limited to):
- 74.1 the commercial rationale for the ownership structures or joint venture structures of related party suppliers of commissioned assets and services to regulated suppliers;
- 74.2 the types of ownership structures of related party suppliers of commissioned assets and services to regulated suppliers;
- 74.3 the terms of the contracts entered into between the relevant parties;
- 74.4 the mix of business undertaken by the related party suppliers with the regulated suppliers and with other unrelated parties;
- 74.5 the reasons for the growing value of related party transactions being disclosed;
- 74.6 why suppliers use certain related party options; and
- 74.7 the extent to which implementation and compliance issues reflect problems of dealing with any of the above from a regulatory point of view.



75. Taking more time to explore any potential problems with the related party transactions regime takes into account Powerco's submission on our problem definition paper, where it made the following statement about timeliness of the IM review:<sup>19</sup>
- ...the Commission should consider whether this review process is the most appropriate time to be considering an issue, or conversely whether it would be more appropriate to address the issue in a future review. The Commission might decide that consideration of an issue is not timely if the issue depends on market developments that are uncertain, or unlikely to crystallise before the next opportunity to review the IMs.
76. We note that submissions from PwC,<sup>20</sup> ENA<sup>21</sup> and Pioneer Energy<sup>22</sup> on our process and update paper,<sup>23</sup> indicated a preference for us to complete a review of the related party regime across both IM and ID together, if not within the same time frame as the IM review. We also note PwC's acknowledgement that the topic area is complex.
77. Having considered the submissions that have been made on our process and update paper and based on our review of the related party transaction IM provisions so far, we do not consider that issues 1–3 need to be addressed urgently.<sup>24</sup> We note that:
- 77.1 with a Gas DPP reset occurring in 2017, we have considered the impact of related party transactions on GDBs and GTBs.<sup>25</sup> Most of the related party transaction expenditure for GDBs and GTBs is in operating expenditure and is therefore not covered by the IMs;
- 77.2 the next EDB DPP reset is not until 2020. Although, we are aware that there is a need for a significant lead-in time for any changes we make to be reasonably bedded in prior to the reset; and
- 77.3 we do not have any immediate compliance concerns that are material enough to demand limited and potentially short-term changes to the IM provisions.

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<sup>19</sup> Powerco "Submission on input methodologies review: Invitation to contribute to problem definition" (21 August 2015), para 21.

<sup>20</sup> PwC "Submission to the Commerce Commission on input methodologies review: Emerging views papers – Made on behalf of 16 Electricity Distribution Businesses" (24 March 2016), para 9.

<sup>21</sup> ENA "Input methodologies review: Emerging views papers – Submission to the Commerce Commission" (24 March 2016), p. 4.

<sup>22</sup> Pioneer Energy "Input methodologies review – Process update paper" (24 March 2016) pp. 1-2.

<sup>23</sup> Commerce Commission "Input methodologies review – Process update paper" (29 February 2016).

<sup>24</sup> As noted in paragraph 80, we are accordingly open to extending the timeframe for our final decisions on the related parties IMs beyond December 2016.

<sup>25</sup> Less than 1% of GDBs' capex and only 2% of GDBs' opex was identified as a related party transaction in 2015. Although significant GTB opex was identified to be related party transactions in 2014 and 2015, the data is incomplete and this may change when the ownership structure of the sector changes under the First Gas transaction.

## Next steps for further work on the related party transactions regime

### *Purpose of the further work on the related party transactions regime*

78. The purpose of the further work is ultimately to further explore whether the identified issues amount to a broader problem with the related party transactions regime and further consider what the best solution to any such problem might be. In doing so:
- 78.1 we will assess the extent to which the related party transaction provisions in both the IM and ID determinations for the EDB, GDB and GTB sectors achieve the policy intent of the related party transaction regime;
  - 78.2 we hope to gain a better understanding of a range of matters relevant to the related party transactions regime, including:
    - 78.2.1 the commercial rationale for the ownership structures or joint venture structures of related party arrangements in relation to commissioned assets and services to regulated suppliers;
    - 78.2.2 the types of ownership structures of related party suppliers of commissioned assets and services to regulated suppliers;
    - 78.2.3 the terms of the contracts entered into between the relevant parties;
    - 78.2.4 the mix of business undertaken by the related party suppliers with the regulated suppliers and with other unrelated parties;
    - 78.2.5 the reasons for the growing value of related party transactions being disclosed;
    - 78.2.6 why suppliers use certain related party options; and
    - 78.2.7 the extent to which implementation and compliance issues reflect problems dealing with any of the above from a regulatory point of view.
  - 78.3 We will propose solutions to any problems identified. Solutions may include:
    - 78.3.1 changes to the related party provisions in the IMs or ID; and/or
    - 78.3.2 providing further guidance or clarifications for suppliers about how the related party transactions regime works.

*Timeframes for our further work on the related party transactions regime*

79. The further work we propose to do on the related party transactions regime would be carried out within the current IM review.<sup>26</sup>
80. If our further work confirms a problem with the related party transactions provisions requiring changes to the IMs, this is likely to extend beyond the December 2016 timeframe for the rest of the review. On the other hand, if our further work does not identify a problem requiring changes to the IMs, we may be able to reach draft and final decisions on the related party IMs by December 2016.
81. We aim to update stakeholders in early September 2016 on our timing for draft and final decisions in respect of the related party transactions IMs.<sup>27</sup>

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<sup>26</sup> Any changes to the ID requirements would be consulted on and made under s 52Q of the Act, rather than under s 52Y.

<sup>27</sup> As discussed in the Introduction and process paper, we anticipate providing a general process update at this time.