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Input Methodologies Review Draft decision on related party transactions

Submission to the Commerce Commission

Final

From the Electricity Networks Association

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1. Introduction

1. The Electricity Networks Association (ENA) appreciates the opportunity to make a submission to the Commerce Commission (Commission) on the consultation paper **Input methodologies (IM) review draft decisions – Related party transactions, 30 August 2017 (draft decision)**.
2. The ENA represents all of New Zealand's 26 electricity distribution businesses (EDBs) or lines companies, who provide critical infrastructure to NZ residential and business customers. Apart from a small number of major industrial users connected directly to the national grid and embedded networks (which are themselves connected to an EDB network), electricity consumers are connected to a distribution network operated by an ENA member, distributing power to consumers through regional networks of overhead wires and underground cables. Together, EDB networks total 150,000 km of lines. Some of the largest distribution network companies are at least partially publicly listed or privately owned, or owned by local government, but most are owned by consumer or community trusts.

2. Submission summary

3. The ENA supports the adoption of a principles-based approach to valuing related party transactions and recommends that the Commission:
 - Review its drafting of the related party draft decision to make the intent clearer, remove ambiguity and reduce the likelihood of unintended consequences from varied interpretations.
 - Reconsider the definition of 'related party' and remove part (b) of the definition in the draft decision.
 - Narrow the scope of the transactions captured by this IM so that the policy intent is better met.
 - Include a de-minimis threshold, and include a carve-out for low value transactions, in the disclosure compliance requirements.
 - Provide greater clarity, including examples, on how the related party and the cost allocation IMs work together. This may be best achieved through a stakeholder workshop.
 - Include an option for the use of cost-based alternative, under which EDBs would be permitted to consolidate the related party (i.e. as if for GAAP) to remove intercompany profit instead of having to test for arm's-length values.
 - Reduce the information disclosure (ID) requirements to ensure that they are proportional, are not overly prescriptive and do not unnecessarily increase compliance costs.
 - Either, reconsider implementation timing (given that members consider this draft decision requires substantial editing to provide greater clarity to EDBs) to reduce the potential for unintended outcomes and to reduce the costs to consumers, or
 - Reconsider the nature and level of the disclosure prescription along the lines of the mark-ups that we provide with this submission, which will improve the effectiveness of the revised IM and ID requirements for related party transactions and allow compliance to be achieved for the 2018/19 regulatory year.

To assist the Commission, this ENA submission is accompanied by our edits as mark up to the amended IM and ID determinations published as part of this consultation.

3. Overview of draft decision

4. The ENA understands that the changes proposed in the draft decision apply to both IM (for capex) and to ID (for opex, revenue and compliance), and that the intention of the draft decision is for the transactions to be accounted for at no greater than arm's length value (and at actual transaction value, where this is less).
5. The draft decision presents the Commission's outputs from its review of the related party IM and includes marked-up versions of both the IM and ID determinations. The changes to the IMs and IDs include:
 - the removal of the current IM and ID prescriptive methodologies for valuing related party transactions.
 - the use of a principles-based approach to value these transactions, (the related party transactions are to be valued at no more than an arm's length basis, using objective and independent measures).
 - the methodology for valuing transactions is to be based on an objective and independent measure, in a transparent manner.
 - removal of the cost-based recognition rules.
 - new disclosure requirements for EDBs involved with related party transactions
 - greater alignment with auditing standards for disclosures of related party transactions
 - additional audit and certification requirements.

4. ENA feedback

6. The ENA recognises the legitimate policy intent behind ensuring related party transactions are no higher than would be obtained in an arm's length arrangement and that EDBs will necessarily have to incur compliance costs in providing confidence to the Commission and other interested stakeholders that this is the case.
7. Overall, we consider that the Commission has reached an appropriate position in proposing a principle-based approach to valuing related party transactions based on accepted accounting standards and assurance standards. But ENA members consider that there are issues with the scope of the proposed disclosure and compliance obligations and with the definition of a related party.
8. In this submission, we make a number of recommendations, which we believe would continue to achieve the Commission's policy objectives, but at lower overall compliance cost. The ENA submits that the proposals are unworkable with respect to the definition of a related party. Further, the proposed disclosure requirements extend beyond assurance of related party transactions, and cover broader operating model information, outside what is necessary to achieve the policy intent.
9. These extended disclosure and assurance requirements would likely lead to significant compliance cost impositions that would ultimately fall to consumers, including the potentially significant opportunity cost associated with demonstrating compliance. If compliance costs become excessive, then this may drive

EDBs to divest from their related parties, placing at risk the efficiencies or cost advantages associated with obtaining services from a related party.¹

4.1. Principle-based general valuation rule is appropriate, but cost-based rules should also be permitted

10. In its submission on the related party problem definition, the ENA argued that the starting point for the review of the related party regime should be the principles for the related party rules and the policy outcomes they are intended to achieve. We continue to agree with the view that the Commission's expressed in its 2016 consultation paper; that there is no issue with the policy intent but that the implementation of the policy intent needs improvement.
11. ENA members consider that the policy intent should remain as previously argued - i.e. to provide for the recovery of fair costs, at no greater than arm's-length prices. The focus of the policy intent should be to seek fair outcomes for both consumers and regulated businesses. We also remain of the view that the focus should be on resolving complexity in the rules to drive better outcomes, rather than on imaginary gaps between policy intent and outcomes.
12. Of note, however, is that the Commission has removed all cost-based rules from the valuation of related parties, including the option to consolidate the costs of the related party into the EDB, which eliminates all profits in the transactions. The ENA is strongly of the view that the Commission should continue to permit EDBs to recognise services using cost-based methods, including the option to consolidate, as an alternative to implementing the general valuation rule. By choosing this cost-based method, EDBs would avoid the need to obtain benchmarking or other market-based information which, in turn, would result in significant compliance cost savings to EDBs and by extension consumers, as well as audit savings, since auditors will be using consolidated information from company accounts.
13. It is also important that any changes to this IM reflect the realities of the market for 'outsourcing' EDB input services. The draft decision appropriately recognises that there are imperfect markets for some services sought by EDBs in some locations, and that related party service providers are a legitimate solution to addressing these imperfect market circumstances, while also providing access to economy of scope and scale benefits.
14. The ENA believes the Commission has made the right decision to remove the prescriptive related party rules and replace them with a principles-based approach. However, application and implementation of these principles should be practical and proportionate. For example, we believe the incorporation of auditing and accounting standards for compliance and evidence purposes is a proportionate response. But there are some aspects of the draft decision that are not.
15. The ENA recommends that:
 - the revised ID compliance requirements should have a de-minimis threshold and include a carve-out for low value transactions.

¹ For example, becoming captive to a third-party contractor in a region where it is not possible to sustain a competitive contracting market.

- The Commission should provide that EDBs may use cost-based rules, including consolidation of the related party, as alternatives to the general valuation rule.
- The information disclosure requirements should be reviewed to ensure they are proportionate. In particular, they should only require the information necessary to evidence the arms-length value, and there should be less prescription about the form in which that information is to be provided. The ENA is willing to assist the Commission to develop appropriate amendments.
- The requirement for an independent assessor should be removed – the use of independent auditors and directors’ certification, together with the Commission’s powers to require further information where necessary, should provide sufficient opportunity for verification.

4.2. Scope and definition are important

16. The ENA is concerned that the definition of ‘related party’ lacks clarity and extends the scope of what is captured under the proposed related party rules beyond what is contemplated by the policy intent. The definition should be narrowed and clarified to avoid the potential for misinterpreting the rules and for including transactions that simply should not be included as a related party transaction.
17. ENA members’ specific concerns relate to the interpretations that can be applied to the second limb of the Section 4 definition, ‘(b) any part, branch or division of the regulated business that does not supply regulated services’. If the Commission extends the related party rules to those parts, branches, or divisions of EDBs that operate, but do not supply regulated services (such as internal legal services), then there will be a greater compliance cost burden on those businesses which will ultimately impact consumers.
18. Members also have considerable concerns about the explanations and examples of ‘related parties’ that the Commission provides through the draft decision paper. The explanation of related party using the figure 4.4 Venn diagram is unhelpful because the example does not specify why the division is a related party and why the cost allocation IM should not apply. The ‘regional lines engineering division’ example does not make clear why this division cannot simply cost allocate its time between regulated and unregulated activities, with recognition of the transaction at the relevant internal salary cost. Under the Commission’s draft decision approach, the regional engineering division, which is not currently a profit centre, would become such a centre, and there would be additional complexities and compliance costs due to removing the shared costs associated with the division from the regulated service.
19. The Commission’s clarification of the current definition of related party:

“any part of the EDB in question that does not supply electricity distribution service”

Is re-defined in the draft decision to read:

“any part, branch, or division of the regulated entity that does not supply the regulated service....”,

which is further clarified:

“... as we regulate the service and not the regulated entity that operates the regulated service, but which does not supply the regulated service, is considered a related party.”
20. Under this definition, it would seem that anything that is not a conductor or cable would be a related party. This would be unworkable (as there would be a significant impost valuing all the services that are

required to operate the network) but also harmful to the achievement of the Commission’s policy objective since these services could now be priced at a profit, rather than at cost, as currently.

21. The ENA submits that part (b) of the definition of a related party should be removed. If the Commission’s concern was that, say, an internal vegetation division be transacted at a price that is the same as it were in a related entity, there is no policy reason to require this. Organisations routinely internalise costs to, among other things, avoid paying for the profits inherent in a related party service, so there will always be a difference in the internal costs compared to a fee for service.
22. There is nothing that legally prevents the Commission from recognising, at cost, the cost input for the support service that provides regulated services.
23. Where the internal division also provides unregulated services, the direct and indirect (shared) costs associated with those services are dealt with under the cost allocation requirements. The ENA would point out that EDBs currently have incentives to improve the efficiency of these internal services by virtue of the operation of regulatory settings such as the price (and, in future, revenue) cap and IRIS mechanisms, as well as their consumer ownership models. Internal divisions are not related parties and the inclusion of them within the revised IM and ID requirements goes beyond the policy intent.

4.3. Information disclosure requirements

24. It is important that the evidence that is gathered under the proposed accounting and audit standards is suitable and fit for purpose in the context of related party transactions. Excessive disclosure requirements impose undue regulatory cost and poorly targeted compliance requirements impose undue regulatory complexity. The IM Review focused on reducing cost and complexity and this is one of the main reasons that these particular IMs are under review. In a general sense, ENA members’ concerns with the proposed disclosure requirements are:
 - they are too prescriptive, and therefore will restrict EDBs from responding in a way that best reflects their own particular related party arrangements
 - they place too little weight on the audit and certification processes
 - they don’t adequately consider materiality or how representative evidence could be best provided
 - they step beyond related party information into broader asset management information
 - they unnecessarily depart from GAAP
 - they are inconsistent with the information required for CPP proposals in support of related party arrangements. These information requirements were reviewed and updated during the 2016 IM Review.
25. Members have particular concerns with the new disclosure requirements as follows:
26. Clause 2.3.10 in the Draft Decision (mapping network expenditure and constraints in EDB AMP and AMP updates) should be removed. As drafted, this clause requires ENA members with related party transactions in their last disclosures, to map various future constraints, and projects, in their AMPs,

regardless of whether the constraint or project would be resolved by a related party or not (refer 2.3.10(3) and 2.3.10(4)). This is not a reasonable requirement for related party disclosures.

27. Further, by introducing the 65% trigger for an additional report, ENA members believe that the Commission has added an unnecessary and costly additional layer of assurance. The transparency provided by expanded information disclosure, coupled with audit assurance and directors' certification should provide sufficient evidence and assurance to establish whether the policy intent is being met. Even if this requirement is retained, the 65% threshold appears arbitrary and will result in a high number of EDBs having to regularly obtain additional assurance reports, with no apparent benefit to consumers. We therefore submit that the requirement for an expert report requirement be removed because the requirements for it are too broad, and:
- there is sufficient evidence provided in the remaining disclosures even for those EDBs where related party transactions are more material
 - the auditors and directors are certifying against the requirements, including for those EDBs with more material transactions and therefore additional assurance is not justified
 - the threshold is arbitrary
 - where an auditor is unable to form a view, the Commission is able to seek further information.
28. ENA members consider that the proposed implementation date of April 2018 may not be realistic because a redraft is now needed, ahead of a 'final' draft decision and then a final decision implemented, all over the next 6 months. Also, EDBs may need to change how they collect and process information, depending on the disclosures that are included in the Commission's final decision.
29. We suggest that some of the specific requirements proposed (particularly in the sub-clauses), are moved to the guidance document. This would allow EDBs more flexibility in responding to the overarching information requirements in a manner which best reflects their particular arrangements. This will result in more meaningful disclosure, as it avoids compiling evidence to meet a compliance requirement where it does not make sense to do so.
30. If the detailed prescription was lightened (as per our marked-up attachments), and the focus of the disclosure requirements was on providing core information necessary to support the principles-based valuation, then a 2018 implementation may not be so problematic. We also note that the CPP related-party IM contains disclosure requirements appear to be more reasonable than proposed in the draft decision, and may serve as appropriate guidance for the Commission to consider in its new draft.
31. In light of the concerns expressed in this submission, members consider that it may be worthwhile to workshop the re-drafting of disclosure measures and include auditors, as they will be at the 'coal-face' of implementation. Members consider it important to make sure that what they are going to be required to disclose is meaningful, practical, and cost-effective, and directly in response to related party arrangements.

4.4. Costs to consumers

32. ENA members are supportive of the Commission's desire for greater transparency through the ID regime about the performance of the distribution sector, including related party transactions, particularly where this is beneficial for consumers. Members submit however that the compliance burden on EDBs is likely to increase from both a lack of clarity in the proposed rules and the increased information disclosure requirements which, taken together, means that costs to consumers will also increase.

Appendix

The Electricity Networks Association makes this submission along with the explicit support of its members, listed below.

Alpine Energy
Aurora Energy
Buller Electricity
Centralines
Counties Power
Eastland Network
Electra
EA Networks
Horizon Energy Distribution
Mainpower NZ
Marlborough Lines
Nelson Electricity
Network Tasman
Network Waitaki
Northpower
Orion New Zealand
Powerco
PowerNet
Scanpower
The Lines Company
Top Energy
Unison Networks
Vector
Waipa Networks
WEL Networks
Wellington Electricity Lines
Westpower