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Dear Keston,

VALUATION OF RELATED PARTY TRANSACTIONS

Introduction and recommendations

This letter is Unison's submission on the Commission's consultation paper: *Input methodologies review draft decision: Related party transactions - Draft decision and determinations guidance* (Consultation Paper).

Unison has read and contributed to the ENA's submission and agrees with its recommendations.

In this submission, we address three key aspects of the Commission's proposals:

1. The definition of a related party;
2. Methods for valuing related party transactions;
3. Information disclosure requirements.

Unison's key recommendations are as follows:

- a. *Remove the requirement to value any "(b) any part, branch or division of the regulated business that does not supply the regulated service" on an arm's length basis.*

As far as we understand it, EDBs currently recognise internal costs of operating and supporting the regulated service at the cost of their provision. We are incentivised to obtain these services at least cost by the operation of the price/revenue cap and IRIS mechanisms. If EDBs were required to value internal services that operate, but do not supply the regulated service, at arm's length values, then this would almost certainly lead to increases in these input costs: an external provider would seek to make a profit, whereas internal service provision is at cost.

- b. *Continue to provide for consolidation at cost as a means of valuing related party services.*

Unison currently consolidates its related party contractor, UCSL, into Unison Networks for Information Disclosure purposes. UCSL's costs are recognised at cost (e.g., the salary and wages of lines workers) with all margins eliminated on consolidation. The efficient overhead costs of UCSL are also consolidated into Unison, with Unison's Directors asked to confirm that these overheads are no more than is required to operate UCSL as a division. This approach:

- a. Provides a cost effective means of recognising UCSL's costs for carrying out Unison's works, including the overhead costs of operating a contracting business;
- b. Ensures that the Commission's concerns about profits are addressed (all margins are eliminated);
- c. Incentivises UNL/UCSL to seek efficiency improvements as a result of price/revenue cap regulation and the IRIS mechanisms; and
- d. Ensures appropriate cost sharing between regulated and unregulated activities. The cost allocation rules (e.g., ABAA) are applied so that shared costs in UCSL are apportioned between regulated and unregulated activities where UCSL is providing electrical contracting services to other parties.

Where the consolidation approach is used, we recommend that there should be no requirement to benchmark to arm's length prices because:

- a. There are likely to be material compliance costs associated with obtaining benchmark information to enable calculation of arm's length prices;
 - b. There will be significant differences between an arm's length price (which includes mark-ups to cover overhead costs and profit requirements) and internal costs under a consolidation approach, which would render comparisons meaningless.
- c. *We support the move to a principle-based approach to valuing related-party transactions, based on accounting standards*

Subject to our recommendation that consolidation should remain as a valid option, as we have said in previous submissions, the current approach to valuing related party transactions is inconsistent between the IMs and ID. In addition, the current more prescriptive approach means that it is difficult to apply the rules in such a way as to achieve full recognition of related party services. The principle-based approach based on adherence to accounting standards provides a sound basis for valuing transactions.

- d. *Compliance costs associated could be substantial, depending on the Commission's or auditors' expectations*

Our experience of obtaining market valuations just for major capital works has demonstrated that obtaining independent valuations is a costly process. There is significant cost associated with an independent expert reviewing the projects, but also significant opportunity cost associated with project managers and project engineers providing information to the valuer to explain the challenges associated with the project, which are not visible on project documentation or when visiting the works.

We recommend the Commission should provide guidance that EDBs may demonstrate compliance with the valuation rules in a manner that is proportionate and cost effective. Unison's past approach of consolidating UCSL into the EDB was a key means of managing compliance costs. But, for those EDBs that elect to value their transactions at arm's length prices, the Commission should provide further examples of the methods that are acceptable to validate related party prices. For example, there may not be examples in every category of expenditure of market benchmarks available to valuers (for example, fault or emergency response services). In such circumstances, the EDB should be entitled to infer from margins on other benchmarked services whether or not the service for which no benchmarks exist is reflective of an arm's length price.

e. Unison does not support the explicit recognition of the Guidelines in the IM

While we think that the guidelines are a useful means of the Commission conveying the policy intentions behind the wording in the IM, we think it would be more consistent with the role of IMs to instead refer to the Guidelines in the Information Disclosure Determination.

f. With respect to the proposed disclosure requirements

a. We support the provision of a diagram showing related party relationships and disclosure of information on procurement policies;

b. Disclosure of practical application of procurement policies;

Where an EDB applies a cost-based approach to recognising the value of the transaction (e.g., Unison consolidates UCSL into the EDB) there should be no requirement to demonstrate the application of the procurement policy. As Unison operates UCSL effectively as a division, if this was a requirement, then the Commission would need to provide for the time and cost of additional procurement staff to re-establish a contract administration function within Unison. In addition, the Commission should note that long-term agreements punctuate contractor relationships as both parties expend significant sunk capital into the arrangement, so there may be an absence of evidence of the operation of the procurement policy with respect to related party transactions;

c. Most recent examples of market testing

The Commission needs to recognise that where EDBs have related parties and intend to continue the related party arrangement, market testing may not occur or be undertaken only infrequently in some aspects of the service. There is considerable effort required in developing a request for proposals as well as responding to it. Third parties would not consider it worthwhile to develop a conforming bid if they were not confident of being able to secure the work. Similarly, the EDB would potentially create damaging uncertainty amongst employees of the related party contractor if they were to seek tenders for services currently being provided in-house. Accordingly, the Commission needs to accept that market testing is most likely to come in the form of EDBs obtaining information from independent valuers.

The Commission suggests that evidence would be required across all major opex and capex categories, but this may not be possible in areas where services are not frequently tendered and valuers do not have access to market data. This may be especially true for maintenance works, whereas capital works projects are more frequently tendered and valuers have been able to accumulate data on the costs of different types of capital projects.

d. Timing

The Commission proposes that the new requirements would come into force from 1 April 2018. In Unison's case, with respect to Unison's contracting business, UCSSL, unless the Commission adopts Unison's proposal to continue to allow consolidation as a method of valuing UCSSL's services, it would take some time to establish market rates across all categories of expenditure and to test these against benchmarks. We therefore propose that the new requirements come into force on 1 April 2019 if consolidation is not an option. We recognise that this would potentially make the price path reset more complex, as adjustments would need to be made for businesses transitioning between cost-based methods of recording related party transaction values and market-based measures, but there is a practical reality that, where businesses have previously used cost-based methods to value related-party transactions, it will take time to transition to arm's length prices.

Unison is only aware of one independent valuer who could provide valuation services for electrical contracting, and if there are numerous EDBs that would require their valuation services, then we would be highly concerned that there would be insufficient valuers to carry out the necessary work to allow timely, unqualified disclosures.

e. Requirement to obtain independent report where more than 65% of transactions are to a related party

We do not support this additional requirement. Auditors will be required to form an opinion on the evidence available that related party transactions meet the general valuation rule. Obtaining an additional report will duplicate efforts and add

additional costs to the verification process, for no discernible benefit. In circumstances where the auditor is unable to form an opinion, then it will be necessary for an EDB to obtain further evidence to support, or otherwise determine the transaction values. In that case, we would expect EDBs to obtain additional expert reports, but we would expect this to form part of the audit process and for matters to be resolved before the transaction values and disclosures are finalised.

f. Requirement to provide network maps of proposed expenditure with related parties

We do not support the provision of network maps of likely expenditure as part of the review of related party transaction rules. We understand the desire from third parties to obtain information on opportunities to provide network alternative services. But, such information is likely to be relevant regardless of whether or not the works may be provided by a related party or independent contractor. We recommend the Commission consider the provision of this kind of information in a review of Information Disclosure requirements.

g. The Commission should consider holding a workshop with EDB's, auditors and valuers to further develop the guidelines and proposals

The Commission needs to ensure that the related party transaction rules are practically workable and can be implemented in a timely basis. There may be merit in holding a workshop with relevant stakeholders to assist in the further development of the proposals.

Further explanation of these recommendations is provided in the remainder of this submission.

Meeting the policy intent of the related party transaction rules in a cost effective manner

The policy intent of the related party transaction rules is to ensure that regulated businesses are unable to shift profits between regulated and unregulated entities and ensure that efficiencies are shared with consumers as improvements occur in the services being procured from related parties. By benchmarking to independent, objective measures of prices the Commission can meet the objectives of Part 4 in *limiting the ability to earn excess profits and sharing of efficiencies with consumers*.

Accordingly, we support the proposal to apply a general valuation rule based on accounting standards, with assurance provided by auditors that transaction values represent arm's length values. Efficiencies in the external contracting market will be passed on to consumers as these efficiencies are reflected in contract prices that form the benchmark information sets used to value transactions.

The Commission has proposed, however, that it will also remove the cost-based valuation rules, including the option to consolidate a related party contractor into the entity providing the regulated service. There is no discussion as to why this option has been removed, but Unison

submits that this option should remain available and is also consistent with achieving the policy objectives of Part 4. In particular, consolidating a related party at cost into the regulated business ensures there is no ability to shift profits between the regulated business and unregulated activity – all profit margins earned by the related party are eliminated on consolidation. Additionally, as with any efficiency gain achieved within the regulated business, under a consolidation approach, efficiencies achieved within the related party contractor are shared with consumers by the operation of the price cap and opex and capex IRIS mechanisms.

The additional advantage of cost-based valuation rules (including consolidation) is that they are simple to implement. As company accounts will require these calculations in any event, compliance costs are reduced, and there would be no requirement to undertake costly studies to determine arm's length prices. Where a related party also undertakes third-party works, the cost recognition and cost allocation rules (ABAA) ensure that direct and shared costs are appropriately apportioned to those third party works.

Definition of a related party

The Commission proposes that internal “parts, divisions and branches” of the legal entity that operate, but do not supply the regulated service, should also be deemed a related party. This would mean, for example, a control room would become a related party service and this would need to be valued at market rates or less. Aside from challenges associated with obtaining benchmark prices for this service, it would seem antithetical to the policy objective of limiting profits for EDBs to be required to strike arm's length prices for services that are currently recognised at cost.

We are unsure of the Commission's reasons for deeming internal services to be related parties, but note the reference to the fact that the Commission regulates the service, not the legal entity and that this requires the Commission to deem anything not directly involved in the conveyance of electricity to be a related party.¹ Unison submits that there is no such requirement. The Commission is free to determine how the costs associated with the provision of the regulated service are to be determined, regardless of how the service is provided. Valuation based on the internal costs of the input are a reasonable method of valuation consistent with the Part 4 Purpose.

If the Commission's reason for determining that in-house inputs required to operate the regulated service should be valued on an arm's length basis is to ensure the same value is recorded regardless of whether the service was provided inhouse, by a related party or an independent contractor, then Unison submits that such requirement for consistency is misplaced. Businesses routinely in-source services to achieve a lower cost as well as align incentives, compared to out-sourcing.

Accordingly, we recommend that the Commission remove the second part of the proposed definition of a related party. Services internal to the legal entity that are required to provide the regulated service should be recognised at cost. Cost allocation rules can then be used to allocate any shared costs or assets that may be used to provide unregulated services. In the Commission's example of “Regional Engineering Services” the salary costs of the engineers, their office space and IT requirements etc would be recognised at cost, with cost and asset

¹ Consultation Paper, Table 4.4, page 58.

allocation rules used to allocate their costs where these services are also utilised in unregulated activities.

Management of compliance costs

Notwithstanding our recommendation that the Commission should continue to permit consolidation as a valid option for valuing related party transactions, if the Commission does not adopt our recommendation, we are concerned that there will be significant costs imposed on Unison if we were required to obtain market benchmarks to value all the services provided by our related party contractor, UCSL. Our experience of seeking independent market valuations of major projects showed that:

1. It is an expensive exercise, both in the costs of obtaining independent valuations and in the internal time spent with the valuers to explain the projects in greater detail than is recorded in the project documentation (e.g., information on the actual ground conditions struck, the impact of weather experienced once the project commenced, etc).
2. There may be challenges for valuers being able to benchmark unusual projects or for services that are not regularly tendered (e.g., fault/reactive services).

Accordingly, we recommend that the Commission should ensure that sufficient guidance is provided to auditors on the need to be pragmatic in assessing transaction values. For example, discretion should exist to extrapolate the findings from benchmark analysis in one area of related party transactions to other related party services where benchmark information may not exist.

Overall, Unison submits that the Commission should ensure that its guidance to auditors enables a pragmatic approach to valuing related party transactions. It will be impractical to market test every transaction, when a related party electrical contractor performs thousands of

jobs for the EDB. There are likely to be circumstances where independent valuers will not have access to observable market transactions, but must infer from other information the value of transactions. Unison submits that the Commission should make clear in its guidance that such approaches are acceptable to ensure that the requirements are both workable and can be implemented at a reasonable compliance cost.

The Commission has proposed that where an EDB obtains more than 65% of opex or capex from a related party, the EDB must obtain an independent valuation report on the related party transactions. Unison submits that the Commission needs to give further consideration to the costs and benefits of such an approach. We can understand the potential requirement for an independent report where the EDB has been unable to provide sufficient information or has been unable to substantiate the value of its related party transactions as arm's length, but otherwise we do not see that there is a net benefit from requiring a further independent report just because a certain threshold is met.

Disclosure obligations

The Commission has proposed a number of additional disclosure obligations to strengthen the information made available to interested parties. While we appreciate that the Commission is concerned to increase the transparency of information, it is also important that the Commission recognise that commercial sensitivity of information is protected. For example, where EDBs both provide related party goods and services and compete to win third party opportunities, it will be important for such EDBs to be able to avoid making public disclosures.

As noted in our "Introduction and Recommendations" Unison is generally comfortable with an increase in disclosure obligations associated with procurement of goods and services from related parties. However, we are concerned that the requirements associated with the provision of information in each major category of opex and capex. Information on market transactions may not exist in every category of expenditure, so it may be necessary to infer arm's length values from other services.

In Unison's case, because we have operated UCSL effectively as an internal division, unless the Commission continues to allow for consolidation, it will take considerable time and expense to implement Unison's procurement policy with respect to UCSL. We estimate that the Commission would need to provide for at least 2-3 FTEs to enable Unison to administer its procurement policy with respect to UCSL and we would expect to incur at least \$100k to obtain an independent report on market values to apply to UCSL's services. As these costs were not allowed for in the 2015 DPP determination, the Commission would need to allow for these costs in an amendment to the DPP Determination, otherwise Unison would be penalised by the increase in these compliance costs for a period of five years under the opex IRIS.

The Commission has also proposed that EDBs with related parties would need to disclose a map of network constraints with the proposed opex and capex expenditures with related parties. Unison understands the demand for this information, but submits that there is wider interest in such information beyond EDB's with related parties. Unison submits that disclosure of this information should be considered as part of a wider review of the Information Disclosure Requirements.

Closing Comments

Overall, Unison considers that, subject to the Commission providing for consolidation as a legitimate approach to valuing related party transactions and ensuring that there is sufficient guidance to auditors about the pragmatic implementation of the general valuation rule, then the proposed changes to the related party transaction rules will be capable of meeting the Commission's policy objectives at reasonable compliance costs. We think there would be merit in holding a workshop with EDBs and auditors to provide further clarity, prior to the start of the disclosure year.

If the Commission does not provide for consolidation of related parties, Unison submits that the Commission will need to provide additional time for EDB's that need to transition to arm's length prices and allow for the additional compliance costs associated with the new requirements under the DPP price path allowance.

We would be happy to discuss Unison's views further with you.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Nathan Strong' with a stylized flourish at the end.

Nathan Strong
GENERAL MANAGER BUSINESS ASSURANCE