

MAJOR ELECTRICITY USERS' GROUP

27 September 2017

Keston Ruxton
Manager, IM Review
Commerce Commission
By email to regulation.branch@comcom.govt.nz

Dear Keston

Input Methodologies review draft decision - Related party transactions

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission (CC) paper, Input Methodologies (IM) review draft decision, Related party transactions, Draft decision and determination guidance, 30 August 2017 (the "draft decision paper").¹ Draft amendments to the IM and information disclosure (ID) requirements were also published as part of the consultation.
2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.
3. The following sections are titled with the 6 topics listed in paragraphs 1.11 of the draft decision. First, we note MEUG's overall response and proposed alternative approach that underpins the responses to the Commission's 6 topics.

MEUG's overall response and proposed alternative approach

4. Related party transactions are a complex issue and there is a balance between improving regulation and not increasing regulatory compliance. Most parties agree there are potentially long-term risks if the status quo related party transactions regime is retained. There is uncertainty on the extent that harm may be occurring at present.
5. All parties agree the industry will change with emerging technologies. The speed and effect of change is not known. That makes designing how to regulate related party transactions challenging.
6. MEUG prefer a precautionary approach that can be adapted quickly in the light of new information and changing market behaviour.

¹ Refer document URL <http://www.comcom.govt.nz/dmsdocument/15705> at <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/related-party-transactions-provisions/>

7. The direction of the draft decision paper to adopt a principles-based approach is welcome.
8. In the rest of this section we explain why we think the proposed implementation of a principles-based approach should be re-considered.
9. The proposed approach in the draft decision paper we term as the “enhanced ID and auditor sign-off” approach. That approach continues to be the right approach for several parts of Part 4 regulation.
10. In our last submission, we suggested an approach of making contracts and arrangements with a related party transparent.² Since that date we have held discussions with Commerce Commission staff and other parties and considered the guidelines and examples in the draft decision paper. Those have tempered our prior suggestion that adopting in full a transparency approach would in the near-term be sufficient.
11. We do think there is though scope for using the benefits of transparency where possible because there is a benefit of timely disclosure.
12. MEUG agrees that some related party transactions are not amenable to transparency and therefore the proposed enhanced ID and auditor sign-off approach is appropriate. Some transactions are amendable to a regime based on making contract information public in a timely fashion. We term this the “continuous disclosure and reserve enforcement approach” comprising:
 - a) EDB publish contracts between their line service business and related party as part of a continuous disclosure regime. This would not be required where a related party wins a contract in an open tender;
 - b) The onus to monitor disclosed contracts lies with interested parties; and
 - c) The Commerce Commission retains reserve enforcement powers.
13. With the proposed enhanced ID and auditor sign-off” approach poor outcomes will not be identified until 5-months after the end of a reporting year. Corrective strategies could take months if not years to implement. With the continuous disclosure and reserve enforcement approach behaviour contrary to the principles-based approach will be identified and mitigation steps taken faster.
14. Delays in identifying and therefore remedial action being taken to address behaviour contrary to the principles of the related party transactions regime can result in:
 - a) An EDB inappropriately banking profits and gaining local market knowledge and local market share and as time goes on being more resistant to unwinding poor behaviour;
 - b) Customers locking in investment and operating practices that may be inefficient because price and service offerings by the related party do not reflect those that would be offered in a competitive market;
 - c) Competitors being locked out and reluctant to re-enter a market with ongoing uncertainty.
15. In the future emerging technologies and likely to see new services and business models introduced into the market rapidly. In a workably competitive market (WCM) information is available promptly to the market and the effect of rapid changes due to emerging technologies would be absorbed and efficient market responses facilitated. We think the continuous disclosure and reserve enforcement approach better reflects WCM than an enhanced ID and auditor sign-off approach.

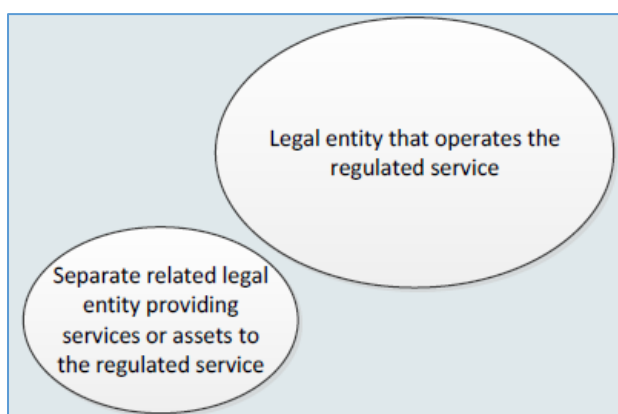
² MEUG to CC, IM review – Related party transactions, paragraph 5 b), 17 May 2017.

16. An example of the incentive for interested parties to engage on detailed contract terms is the concurrent discussion by Transpower on their draft Transpower Works Agreement. A submission lodged by MEUG yesterday is attached to illustrate the detailed feedback we, on behalf of MEUG members that are actual or potential contract counterparties to Transpower, wish to discuss. Had a regulator or auditor been between Transpower and MEUG members the engagement at this level of detail would not have been possible and the outcome therefore less stable and effective for all parties. In a fast-changing sector where the boundary between monopoly and competitive markets is changing due to emerging technologies, use of auditors and regulators needs to be weighed against the benefit of direct market participant engagement.
17. **CC topic 1: our proposed principles-based approach for the general valuation rule, and our proposed reliance on the work of auditors to test the application of the rule**
18. MEUG agrees with the change to a principles-based approach and the specification of the general valuation rule.³
19. MEUG does not support the proposed reliance solely on the work of auditors to test the application of the rule because the enhanced ID and auditor sign-off approach fails to allow timely and effective market response as discussed in the preceding section. MEUG suggests EDB be subject to two parallel regimes as follows depending on the 2-tiers in table 4.4 of the draft decision paper:

- a) Where the related party transaction is:

“a person that is related to the regulated business, where the regulated business is considered as the ‘reporting entity’, as specified in the definition of ‘related party’ in NZ IAS 24.”

As illustrated in the draft decision paper:

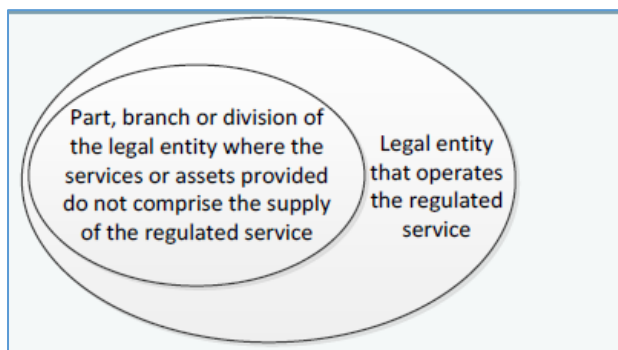


Then the continuous disclosure and reserve enforcement approach should apply.

³ Refer new defined term in ID requirements for “Arm’s-length transaction”

- b) Where the related party transaction is:
“any part, branch or division of the regulated business that does not supply the regulated service.”

As illustrated in the draft decision paper:



Then the enhanced ID and auditor sign-off approach should apply.

CC topic 2: our proposed high level ID areas, and whether there are any other disclosures which could be of material value to stakeholders

20. MEUG has two suggested changes:

- a) The draft decision paper requires EDB to make public “its current policy in respect of the procurement of assets or goods or services from any related party” or “alternative documentation which is equivalent to a procurement policy in respect of the procurement of assets or goods or services from any related party.” The draft ID amendments propose EDB disclose this material in full to the Commerce Commission (cl. 2.3.8) but only a summary must be made public (cl. 2.3.7). No rationale is set out in the draft decision paper why customers should not view the full policies of EDB.

For interested parties to assess the efficacy of auditor reports we need to also see in full the procurement policies of EDB otherwise we haven’t advanced much further from the status quo in understanding the details of how EDB assess risk and price related party transactions.

- b) ID requirements propose changes to schedule 5b(i) consistent with the new components defined in new terms “capital expenditure category” and “operational expenditure category”. MEUG suggests each of those be split into 2 being either one of the 2-tier categories in table 4.4 of the draft decision paper and summarised in paragraphs 11 a) and 11 b) above.

An example of adopting this change follows. The draft proposal requires the price (that is the cost) of vegetation management services to be disclosed as a lump sum for the year ended 5-months prior. MEUG’s proposal would split that lump sum into 2-parts. One part being vegetation management services by the related party provided by a separate legal entity and other part supplied by a related party that was not a separate legal entity. Discriminating the disclosures in this way may assist identify poor behaviour depending on the relationship between the regulated line service and the related party. The ID disclosed for legally separate related party’s might also be separated into contracts won in an open tender and those not so.

CC topic 3: whether our proposed implementation of specific disclosure requirements is appropriate for these proposed high level ID areas, taking into account submitters' views on the extent of the problem being addressed by changes to the provisions

21. See above feedback on topic 2.

CC topic 4: the additional independent report requirement for regulated suppliers with a high level of related party transactions

22. MEUG does not support this proposal. The need for additional focus on an EDB potentially acting outside the principles-based approach using the general valuation rule should be signalled by the auditor signing-off the new disclosure requirements. If there appears to be a problem that should trigger compliance work by the Commission and that may be an additional independent report.

CC topic 5: regulated suppliers that use related parties for opex or capex publishing a forward-looking map of anticipated network expenditure and network constraints consistent with the asset management plan (AMP)

23. An adjustment to the AMP requirements to require this is supported. We understand AMP already require all EDB to identify anticipated network expenditure and network constraints so a requirement the EDB indicate where capex and opex to address those will be allocated to a related party rather than tender would be useful.

CC topic 6: suggested changes to what we are proposing to make the related party regime more effective, in particular our proposal to incorporate the accounting and auditing standards by reference into the IM and ID determinations

24. Incorporating the accounting and auditing standards by reference into the IM and ID determinations is sensible.

Yours sincerely



Ralph Matthes
Executive Director