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Input Methodologies review – Topic paper 7, related party transactions

Submission to the Commerce Commission

Final

From the Electricity Networks Association

Contents

1.	Introduction	3
2.	Submission summary	3
3.	Overview of consultation paper	4
4.	Process and objectives for related party review	4
	4.1. Discussion.....	4
	4.2. Recommendation.....	5
5.	Issues identified by the Commission	5
	5.1. Interpretation and application issues	5
	5.2. IM and ID alignment	6
	5.3. Trends in related party transactions.....	6
	5.4. Recommendations.....	7
6.	Appendix	9

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 review draft decisions – Topic paper 7 – Related party transactions, 16 June 2016 (Related party paper)**.
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 recommends that:
 - The starting point for the review of the related party regime should be the principles for the related party rules and the outcome they are intended to achieve.
 - The objective should be to provide for the fair recovery of costs, at arm's-length prices, with consistency between EDBs and transactions based on evidence.
 - The term 'directly attributable costs' as it applies to related party transactions inappropriately links cost allocation requirements and related party transactions and this link should be removed.
 - The directors' certification option should not be restricted to circumstances where no other option is available.
 - The input methodology (IM) and information disclosure determination (IDD) related party requirements should be aligned.
 - The Commission should engage with electricity distribution businesses (EDBs) where it wishes to better understand a particular trend in related party transactions.
 - The Commission should be careful when considering related party trends to understand the underlying drivers, which may include business strategies, bringing contracting activities in-house and the application of the 2012 IDD.
 - The Commission reconsiders its assessment of avoided cost of transmission (ACOT) payments as the analysis appears to be based on a misunderstanding of the distributed generation pricing regime.

3. Overview of consultation paper

4. The Related party paper:

- Considers that the policy intent behind the related party provisions remains appropriate. The policy intent is stated to be: “to ensure that related party arrangements cannot be manipulated by regulated suppliers in a way that allows them to extract excessive profits”.¹
- Identifies issues that suggest there may be scope for improvements in the related party provisions. These issues are:
 - Interpretation of the term ‘directly attributable costs’ (although we consider the issue is in fact the linkage this term creates between cost allocation and related party transactions) and recovery of indirect costs through margins
 - Appropriateness of the directors’ certification option
 - Alignment of the provisions between the IMs and information disclosure
 - The increase in value of related party transactions across the industry.
- Notes that the Commission does not have a complete problem definition on this topic and intends to take more time to further explore the issues and consider the best solution(s)
- Indicates that the review of the related party provisions is likely to extend beyond December 2016
- Notes that the intention is to provide stakeholders with an update on the timing of the draft and final decisions regarding related parties in September 2016
- Puts forward a series of questions on matters the Commission would like to better understand regarding related party transactions.

4. Process and objectives for related party review

4.1. Discussion

5. From the Related party paper, it appears the Commission’s review is focusing on a few particular issues that have been identified either by the Commission or submitters. While this is reasonable, it is also necessary to step back and consider the broader principles and objectives of the related party rules and how they can best be achieved.
6. We are not convinced the policy intent stated in the related party paper (to ensure that related party arrangements cannot be manipulated by regulated suppliers in a way that allows them to extract excessive profits”) is meaningful. The intention should be to provide for the fair recovery

¹ Related party paper, paragraph 21.

of costs, at arm's-length prices, with consistency between EDBs and transactions based on evidence (as with the current related party requirements, there should also be the ability to apply less stringent rules in de minimis situations).

4.2. Recommendation

7. The ENA recommends that:

- The starting point for the review of the related party regime should be the principles for the related party rules and the outcome they are intended to achieve.
- The objective should be to provide for the fair recovery of costs, at arm's-length prices, with consistency between EDBs and transactions based on evidence.

5. Issues identified by the Commission

5.1. Interpretation and application issues

8. The Related party paper agrees with submissions that the term 'directly attributable costs' is difficult to interpret in the context of related party provisions. We agree this term is problematic and support consideration of a different approach. However, it should be recognised that the problems are caused by the linkage this term creates between the cost allocation IM and the related party rules. In principle an EDB should be able to achieve the same outcomes from a regulatory cost-recovery perspective whatever structure it applies. However, depending on the cost allocation approach it takes and the related party valuation option it applies, the outcomes can differ. This needs to be addressed.
9. The Related party paper also notes that some concerns have been raised that the directors' certification option is problematic, either because:
 - It is a difficult certification for directors to reasonably make, or
 - The wording of the determination restricts this option to circumstances where no other option is available. It is possible for another option to be technically available but not deliver sensible outcomes.
10. The Commission is not yet convinced these are problems that require a change to the IMs. The ENA considers that the wording of the related party clauses does create difficulty in applying the directors' certification option where another option is technically feasible.
11. The Related party paper notes that the option of applying a margin onto directly attributable costs of a related party's contracting services may be confusing. The ENA supports a review of this item. While this option is not part of the IMs – it is available only in the IDD – it is sensible to review it alongside the other related party transaction provisions.

5.2. IM and ID alignment

12. The Related party paper acknowledges submissions that the related party provisions in the IMs and in the IDD could be better aligned. The ENA considers that making these provisions consistent (e.g. in terms of sequencing, terminology and criteria) should be an objective of the review of the related party provisions.

5.3. Trends in related party transactions

13. The Related party paper notes the value of related party transactions has been increasing, both in absolute terms and as a proportion of total opex. It notes that some regulated suppliers have large volumes of related party transactions but others do not. The paper also notes an increase in the value of ACOT payments made by EDBs.
14. The Related party paper asks the following questions intended to help the Commission better understand the observed trends:
 - Why has the value of related party transactions been increasing? Is this driven by genuine commercial efficiency or for regulatory reasons?
 - What is the impact and magnitude of the observed trends on the long-term benefit to consumers?
 - Why do suppliers choose the transaction valuation methods they use?
 - Are there policy, interpretation or compliance issues that need to be considered? What is the best response to these issues?
 - 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?
15. The ENA notes that the answers to these questions will vary across EDBs and are likely to be company specific in most cases. We suggest the Commission holds an industry workshop to better understand any trends that appear confusing.

Drivers of related party transactions

16. As a first point it is not necessarily the case that a higher volume of related party transactions is indicative of a problem.
17. Additionally, as EDBs seek to develop new business opportunities and expand their competitive business offerings, the scale of related party transactions may increase. Increased related party transactions would thus reflect increased commercial activity by the EDB. Increased related party transactions could also reflect decisions to bring business units in-house and provide services themselves.
18. It may also be relevant that the new IDD was published in October 2012. The publication of new disclosure requirements regarding related party transactions may have led to an increase in reporting of such transactions. This is particularly the case in relation to the definition of related party in the IMs, which includes:²

² EDB IM Determination, page 28, definition of related party.

“(b) any part of the EDB in question that does not supply electricity distribution services”

19. This has been interpreted to identify business units within the same legal entity as the EDB as related parties to the EDB. It may be that as EDBs have become more familiar with this clause they have identified business units that could be treated as related parties, even if they were not disclosed as such previously.

Avoided cost of transmission

20. In relation to ACOT, the Related party paper states “ACOT payments have been increasing at a much higher rate than generation over the last four years”. The Related party paper also identifies variations in per-kWh payments across EDBs.³
21. The ENA does not agree that the trends identified in relation to ACOT are indicative of a problem. The analysis may have misunderstood the basis for ACOT payments. Typically EDBs pay ACOT where the operation of a distributed generator at peak times has reduced that EDBs’ contribution to the regional co-incident peak. There is no discretion to pay related party distributed generators differently from distributed generators owned by third parties. ACOT payments are not based directly on the kWh produced by a distributed generator, but by that generator’s contribution to reductions in peak demand.
22. The main reason ACOT payments have been increasing will be due to Transpower’s investment programme. There are, to put it simply, more transmission charges for transmission customers to avoid and therefore ACOT payments can be expected to increase. A comparison of ACOT payments with generation output is not very relevant as year-on-year generation volumes are not very closely linked with the scale of Transpower’s revenue requirement.
23. A further reason for increased avoided cost of transmission payments could relate to EDBs that have purchased spur assets from Transpower and received an associated benefit.

5.4. Recommendations

24. The ENA recommends that:
 - The term ‘directly attributable costs’ as it applies to related party transactions inappropriately links cost allocation requirements and related party transactions and this link should be removed.
 - The directors’ certification option should not be restricted to circumstances where no other option is available.
 - The IM and information disclosure determination IDD related party requirements should be aligned.
 - The Commission should engage with EDBs where it wishes to better understand a particular trend in related party transactions.

³ Related party paper, paragraphs 65-66.

- The Commission should be careful when considering related party trends to understand the underlying drivers, which may include business strategies, bringing contracting activities in-house and the application of the 2012 IDD.
- The Commission reconsiders its assessment of ACOT payments as the analysis appears to be based on a misunderstanding of the distributed generation pricing regime.

6. Appendix

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

Alpine Energy
Aurora Energy
Buller Electricity
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