Aurora Energy Limited

Submission to the Commerce Commission

on its

Draft Amendments to Decisions 710 under s52X of the Commerce Act 1986

1 June 2012

Introduction

1. The Commerce Commission has recently released its *Consultation on Electricity and Gas Input Methodology Determination Amendments 2012.*

2. The Commission is seeking feedback on its draft Input Methodology (IM) decisions, and has set a due date of 1 June 2012 for submissions.

3. Aurora welcomes this opportunity to comment on the Commission's draft determination. Aurora is a party to submissions made by the Electricity Networks Association (ENA) on behalf of 29 Electricity Distribution Businesses (EDBs). Aurora is in agreement with the matters raised in the ENA's submission; however, we wish to make a separate submission to emphasise certain key matters of concern to Aurora.

Consistency with the Part 4 Purpose Statement and Subpart 3 Input Methodologies

4. Section 52A of the Commerce Act 1986 provides, in relation to regulated goods or services, that:

   "The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services –

   (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and

   (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and

   (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and

   (d) are limited in their ability to extract excessive profits."

   and section 52R of the Commerce Act 1986 provides, in relation to Input Methodologies, that:

   "The purpose of input methodologies is to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services under this Part."

5. Aurora is in complete agreement with the concerns expressed in the ENA submission, that the Commission's proposal to introduce a nil value, fall-back, provision for the value of assets acquired from related parties is inconsistent with the Part 4 purpose statement. It is difficult to understand how the Commission contemplates that incentives to invest are provided by a set of rules that may result in the value of any investment being wiped out. That the Commission may consider it unlikely that the default option will apply seems to us to be largely irrelevant in the context of applying the Act.

6. Aurora also has a more general concern that the development of new and amended input methodologies, well into the regulatory period, is doing nothing to promote certainty for suppliers; in fact, quite the opposite. When considered in conjunction with the late development of other regulatory instruments, we also take the view that incentives to invest are further being eroded.

A One-Size-Fits-All Approach

7. Aurora is concerned by the one-size-fits-all approach that has been applied to related party transactions. While we acknowledge that the majority of electricity distribution related parties are either business units or subsidiary companies of EDBs, this is not universally true. In Aurora's case, the related party is a sister company and, being so structured, we would argue that Aurora is unable to exert the degree of management influence that might occur in a subsidiary relationship.

8. An owner of a contracting company should be able to expect, *ceretus parabus*, to earn a normal return in its investment, having due regard to the risk and competitive nature of the business. The Commission's proposal for option 7, where an owner invests, separately, in a contracting business and an EDB (as occurs with Dunedin City Holdings Ltd), can be construed as interfering with the unregulated market by transferring recoveries for profit and overheads from the related party contractor to EDB consumers.

9. Further, there are alternative procurement practices available for the acquisition of assets that achieve competitive outcomes, and for which the Commission's proposal makes no accommodation. As an example, Aurora has for many years allowed consumer's that require network extensions for new supplies to select from a range of approved contractors, on the basis that, acting reasonably, the consumer will accept the lowest conforming price. This incentive is strengthened by the fact the consumer's capital contribution is linked to the asset value, which reduces as the cost of constructing the asset reduces.

10. Aurora recommends that the Commission consider how alternative and innovative procurement practices may be accommodated by the proposed IM amendments.

Preferred Service Procurement Models

11. Aurora reiterates its previous concerns[1] that the Commission is using regulation to force EDBs to adopt a preferred model of service procurement. The "illusory" nature of some options available to EDBs is such that Aurora considers that only outsourced and integrated models of service procurement are acceptable to the Commission. Aurora views it as likely that these two models will largely be adopted by EDBs according to the regulation imposed on them:

    a. Exempt EDBs, that receive weak regulatory incentives for economic efficiency, are likely to reintegrate subsidiary service providers into the EDB operations, and self-construct assets. The community ownership of exempt EDBs results in some different business drivers to non-exempt EDBs – for example, their role as a community employer may result in an aversion to adopting an outsource model if it is perceived that net employment will reduce.

    b. Non-exempt EDBs are likely to adopt an outsource model, given the inherent commercial drivers of private ownership.

12. The above view assumes, of course, that the Commission does not intend to categorise self-construction as a related party transaction. That is, where the EDB has an integrated service group that is not operationally separated as a business unit, or structurally separated as Limited Liability Company.

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[1] Aurora Energy Limited, Submission to the Commerce Commission on its Draft Commerce Act (Electricity Distribution Services Information Disclosure) Determination 2012 and Companion Draft Reasons Paper - Information Disclosure Requirements for Electricity Distribution Businesses and Gas Pipeline Businesses, p4, paragraph 22.

13. It may be, however, that specific circumstances preclude a non-exempt EDB from implementing a outsource procurement model. A typical example would be where the market for asset construction services is particularly weak.

14. Aurora echoes the concerns voiced by PwC, in its submission to the Commission on the draft Information Disclosure (ID) determination, that "*any regulatory mechanism should avoid encouraging businesses to choose their operational structure based on the regulatory rules rather than the underlying economics of the business.*"[2] Aurora considers that the Commission's proposal risks unintended outcomes, as described in paragraphs 31 to 33.

The Options Examined

15. Aurora considers that the Commission has developed a largely disingenuous range of options for EDBs to select from, in order to comply with the proposed IMs. That is, a number of the options available to EDBs have thresholds that are so difficult to achieve, or are so complex and expensive to adopt, that they merely create the illusion of choice.

16. Option 1 provides that the asset may be acquired at "*the transaction value, where the cost of all assets acquired from any related parties in a disclosure year is less than 1% of the regulated supplier's total regulatory asset base value in that disclosure year*". This appears to us to be a particularly low threshold which, to give it some context, represents less than a third of the national average ratio of annual deprecation to closing asset value[3].

17. Option 2 provides that the asset may be acquired at "*the transaction value, where the cost of all assets acquired from any related parties in a disclosure year is less than 20% of the cost of all assets commissioned by the regulated supplier in that disclosure year*". For this option to be available to an EDB, a vigorously competitive market for contracting services would need to exist and, assuming similar competencies deliver similar strike rates, would require in excess of five active contractors to be able to come in below the materiality threshold.

18. Option 3 provides that the asset may be acquired at "*the transaction value, where the related party makes at least 75% of its sales of assets to unrelated parties and the prices charged to the regulated supplier are demonstrably the same as those charged to unrelated parties*". This is a high threshold to meet and, for a related party that is an electricity distribution contractor, implies that it would, as a minimum, have to be engaged by four or fewer EDBs for equivalent or greater volumes of service. Oddly, and for reasons not explained by the Commission, an EDB whose related party contractor offers multi-disciplinary services is further prevented from meeting this threshold if the related party contractor sells assets to another related party. Disturbingly, this threshold is determined against the mix of sales of an unregulated related party contractor, rather than the activities or behaviours of the regulated EDB.

19. Option 4 provides that the asset may be acquired at "*the transaction value, where the type of asset in question has previously been acquired by the regulated supplier from an unrelated party within the last 3 years and the regulated supplier can demonstrate that the cost of supply from its related party (taking account of inflation) was the same or less than the cost of the similar type of asset incurred under the previous arrangement*". Aurora considers that this may have some transitional value, as detailed in paragraph 25; however its attendant administration cost ensures that it is not a credible option on an on-going basis.

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[2] PwC, Submission to the Commerce Commission on Draft Commerce Act (Electricity Distribution Services Information Disclosure) Determination 2012, 9 March 2012, p.22, paragraph 107

[3] Based on 2010/11 information disclosure, and excluding Orion New Zealand Ltd.

20. Option 5 provides that the asset may be acquired at "*the transaction value, where an open competitive tender process has been used by the regulated supplier and the asset was acquired pursuant to the lowest conforming tender price*". Aurora considers that this is the only credible option available to EDBs in the long-term, short of self-construction, and views this as the Commission's preference for service procurement by EDBs.

21. Option 6 provides that the asset may be acquired at "*the transaction value, where verifiable documentation exists which is sufficient to demonstrate objectively that the price charged to the regulated supplier for the asset is equivalent to an arm's length price*". A further requirement is proposed (Consultation Paper, para. 37, p7) that requires a Directors' certificate for each individual transaction treated according to this option. Again, the administrative burden and associated cost ensures that this option is not viable in the long term. It is noted that the Commission provides no comment on how this option might be practically implemented, or what would constitute verifiable information.

22. Option 7 provides that the asset may be acquired at "*a cost limited to the depreciated historic cost of the asset to the related party determined by applying generally accepted accounting practice as on the day before the acquisition by the regulated supplier, if sufficient records are obtained and are elected to be relied on by the regulated supplier to establish this amount*". Aurora considers that this option is excessive and punitive, in that it is highly likely that it will result in the EDB recording the asset at well below market value, even if the market for contracting services was vigorously competitive. The proposal further impacts owners, since the depreciated historic cost is likely to be determined from the related party contractor's job costing system used to track the cost of construction, and will not include any allowance for the recovery of overheads.

23. Option 8 provides that the asset may be acquired at "*a cost limited to the market value of the asset as at its commissioning date as determined by a valuer*". Again, Aurora considers that the cost and administration of obtaining a valuer's report for each (implied by the singular) asset's construction rules this out as a credible long-term option.

24. Option 9 provides that the asset may be acquired at "*in all other cases, the asset acquisition value should be recorded for regulatory purposes at a nil value*". The Commission explains that this option is necessary in order to "*incentivise a supplier with a material amount of related party transactions to take the steps necessary to avail itself of one of the other options*". Clearly, this is an untenable option for EDBs. It does provide the incentive for EDBs to consider alternatives; however Aurora finds it difficult to distinguish between the incentives provided by this option, and the incentives provided by all but option 5. Further, we consider this option to be inconsistent with the Part 4 purpose, as outlined in paragraph 5, above.

Option 4 as a Transitional Arrangement

25. Aurora has previously identified (paragraph 19) that option 4 may have some limited value as a transitional arrangement, if an EDB is unable to adjust its procurement arrangements in sufficient time, or if the Commission contemplates retrospective application (see paragraphs 34 to 37, below). Unfortunately, the manner in which this option is constructed means that the EDB must use an additional valuation method if a related party transaction is greater than the equivalent unrelated party transaction.

26. We consider that this option should allow an EDB to examine its recent historic transactions with unrelated parties, determine the greatest transaction value for a given asset acquired from an unrelated party, and effectively apply this as a cap to the value that may be attributed to an equivalent asset acquired from a related party.

27. The practical difficulty that this poses for EDBs is generally in extensions to the distribution network, which cannot be readily categorised as a discrete asset. Rather, these tend to be a collection of discrete assets (cables, transformers, poles, switchgear, etc.).

28. Aurora's current purchasing arrangements allow us to determine values for major equipment; however many projects simply have lump sum values for (say) "LV Cable", irrespective of size, and the regulatory framework no longer contains any standardised sub-classification of assets (i.e., heavy, medium, light, etc.) that might have assisted to determine the equivalency of assets acquired from related and unrelated parties.

29. Aurora recommends that the Commission determines a standardised asset sub-classification to assist EDB comply with option 4, or alternatively, allow some latitude for EDBs to classify equivalent assets themselves, in a manner that most makes sense to them.

30. Additionally, Aurora recommends that option 4 be amended so that it acts as a cap to the value of related party transactions, as described in paragraph 26, above.

Drivers for Related Party Contracting

31. Aurora considers that the emergence of related party contracting has occurred for a number of reasons. While accepting that related party transactions *could* be used to extract excessive profits on a consolidated basis, Aurora considers that related party contracting emerged for quite different reasons:

    a. Firstly, following the enforced corporatising of local government electricity undertakings in 1990, many EDBs progressively segregated their service delivery (contracting) operations in a drive to encourage greater efficiency and productivity.

    b. Secondly, contracting operations were identified, quite legitimately, as a separable investment opportunity that could be developed to service not only the parent (or sibling) EDB, but other EDBs and a range of industry.

32. Competition for EDB work has ebbed and flowed since, and larger EDBs appear to have no particular problem in maintaining an effective competitive market. However, since around 2003, aggressive offshore competition (particularly from Australia) for skilled labour has seen some smaller EDBs struggle to maintain a competitive market for outsourced work. Aurora has observed at least one instance where the contracting environment was both small and vigorously competitive, to the extent that the mainly owner-operator contractors felt they were constrained from undertaking training and plant replacement. Responding to legitimate concerns regarding the sustainability of service provision, the EDB in question chose to re-establish related party contracting.

33. Aurora urges the Commission to take heed of the experiences of EDBs, understand the drivers for the procurement decisions they make, and adjust its proposals accordingly to ensure that it does not generate perverse outcomes, to the detriment of consumers.

Implementation

34. The Commission has indicated "*that the proposed changes should come into effect upon publication as a notice in the Gazette*". What is not clear, however, is the timeframe for implementation.

35. Aurora believes that EDBs must be given a reasonable opportunity to adjust their procurement arrangements to comply with the regulatory rules proposed. Aurora considers that it would be manifestly unfair to require EDBs to apply the proposed IMs retrospectively, particularly if,

in order to do so, they would have to rely on one of the more onerous options available to it. It is entirely possible that, by being compelled to using the more onerous compliance options to retrospectively value asset additions, any efficiencies / benefits derived would be fully eroded (or worse) by the cost of doing so.

36. Retrospective application of the IMs would be exceptionally difficult to achieve prior to the current proposed due date for 2011/12 ID (now proposed for 31 December 2012). By slipping its ID timeline, the Commission has now shifted a significant task on top of a period when most EDBs are engaged in conducting price reviews. To require retrospective application is likely to make an already tenuous situation worse.

37. Aurora, then, recommends that the Commission require that the amended IMs be applied to asset additions commissioned on, or after, 1 April 2013.