Submission to Commerce Commission

on

Input methodologies review

Invitation to contribute to the problem definition

21 August 2015

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Introduction

1. Alpine Energy Limited welcomes the opportunity to submit on the Commerce Commission's *Input methodologies review—Invitation to contribute to problem definition*.

2. This submission's focus is on:

   i) complexity and compliance costs, specifically related party transactions

   ii) reminding the commission that the simple fixes to correct for errors and provide clarity are also important.

3. In this submission we recommend that as part of the IMs review the commission:

   i) review the related party transactions IM:

      a) definition of directly attributable and not directly attributable costs; as the definitions are too narrow

      b) the method used to set the 17.2% threshold; as the threshold is too low to be of practical use

      c) whether the eight options might be added to and/or amended.

   ii) make the time to progress the simple fixes that have been brought to its attention at other consultations to correct for errors and to provide much needed clarity.

4. In all other matters our views are expressed by the Electricity Networks Association's (ENA) and PricewaterhouseCooper's (PwC) submissions.

5. No part of our submission is confidential.

Related party transactions

6. Clause 2.2.11(g) of the input methodologies[1] (IMs) provides for how electricity distribution businesses (EDBs) value commissioned assets acquired from a related party. NETcon Limited, as our wholly owned subsidiary, is a related party.

7. Sub clause (5) requires that we demonstrate that the price paid to NETcon for assets commissioned and/or acquired must fit one of eight options[2] (a) to (i).

8. Our issue is that we can only apply option (h)—that being, if none of the options (a) to (g) can determine the price, then two or more directors can sign and affirm the value

[1] Commerce Commission, *Electricity Distribution Services Input Methodologies Determination 2012, consolidation* as of 11 December 2014, 30 March 2015.
[2] Supra n1, clause 2.2.11(5)(a) to (h),

of a related party transaction reflecting the price that would be received in an arm's length transaction.

9. Director certification in our mind is less than ideal for appropriately demonstrating that we are not inflating the value of the regulatory asset base (RAB) through prices charged to us for work done by NETcon. It is not ideal as it is asking the directors to delve into the operations at a level that is not appropriate for directors to be at.

10. Our strong preference is to apply option (g). However the 17.2% threshold imposed by clause 2.3.6 (1)(b)[3] of the information disclosure requirements (IDs) makes it impossible for NETcon to recover its costs for the Alpine Energy Limited Group 'shared services'.

11. Our assessment of the eight options can be found at Appendix A of this submission.

How NETcon wanted to recover its costs from us

12. As at 1 April 2015 we entered an Alliance Agreement with NETcon. The agreement specifies that the price paid to NETcon, for works done, will be made up of 'Limbs'.

    Limb 1—the direct costs incurred by NETcon in undertaking work for us excluding overheads or other indirect costs.

    Limb 2—maximum of 17.2% of the Limb 1 direct costs to recover overheads and indirect costs incurred in providing electrical contracting services.

13. On the face of it the method appears to be consistent with the IMs, which allows NETcon to value its contracting work up to 17.2% above directly attributable costs. Unfortunately, the independent review of the Limbs by PwC brought to our attention that the method does not meet clause 2.2.11(5)(g) of the IMs. Accordingly, the method could not be used for the purposes of demonstrating that we are not inflating the value of the regulatory asset base (RAB) through prices charged to us for work done by NETcon.

14. The key issue lies with which costs should be included in the Limbs and which should not.

15. Upon the completion of a job plant, subcontractor, labour, and materials costs are attributed to specific projects undertaken for either us or a third party. It is therefore simple to categorise these costs as directly attributable costs.

16. Corporate labour, admin, audit fees, bank fees, and loose tools are treated as shared costs as these costs are not specifically attributed to projects undertaken for specific parties. It was intended that the shared costs be allocated between us and

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[3] Commerce Commission, *Electricity Distribution Information Disclosure Determination 2012 – (consolidated in 2015)*, 24 March 2015.

third parties; tthen our allocated shared costs are further allocated to either directly attributable (Limb 1) or not directly attributable costs (Limb 2).

17. However, the review's conclusion was that none of the costs at paragraph 16 could be considered directly attributable and that all those costs were expected to be recovered in the mark-up on directly attributable costs, of up to 17.2%, in accordance with the regulatory framework.

What are directly attributable costs?

18. Directly attributable costs are costs incurred that are 'wholly and solely' related to the supply of a single regulated service.

> Directly attributable means, in relation to—
>
> (a) operating costs, wholly and solely incurred by the EDB in or in relation to its supply of one regulated service;
>
> (b) regulated service asset values, wholly and solely related to an asset used by the EDB in or in relation to its supply of one regulated service.

How do we determine directly attributable costs?

19. We determine whether a cost is wholly and solely for the provision of electricity distribution services by asking whether the cost would have been incurred if the electricity distribution network did not exist.

20. For example, we own smart meters as a meter equipment owner (MEO). If the electricity distribution network did not exist we potentially could still earn revenue as an MEO by metering other services (e.g., reticulated gas, water, etc.). Therefore the costs associated with being an MEO are not directly attributable to the provision of the regulated service.

21. We consider that a portion of the shared costs could be directly attributable as those costs would not have been incurred if the electricity distribution network did not exist. However, the narrow definition of directly attributable and not directly attributable costs does not allow for any shared costs to be directly attributable.

22. Accordingly we recommend that the commission revisit the definition of directly attributable as part of the IM review.

What is the problem with the 17.2% threshold?

23. Our problem is that by defining all shared costs as not directly attributable costs the 17.2% threshold—

direct costs x 17.2% = recovery of indirect costs

does not allow NETcon to recover for the group shared costs.

24. The obvious solution to our problem is to shift the shared services from NETcon to us. We are, however, reluctant to do so. We use a shared services model because we believe that NETcon is able to provide these service more efficiently as a participant in a competitive market than what we can as a monopoly.

Our concerns around the threshold are not new

25. The concerns around 17.2% being the mark-up threshold were raised by EDBs when the IMs were set in 2010 and again when the information disclosure requirements were reviewed in 2012. EDBs were concerned that the method on which the commission had set the threshold was flawed resulting in a threshold that was not sufficient to support the appropriate recovery of not directly attributable costs.

26. To set the threshold[4] the commission identified the margins on sales over time for 12 electrical contracting businesses:

    - one Australian
    - one United Kingdom
    - 10 United States of America
    - none from New Zealand.

27. The gross/profit sales margin range was between 33.2% and 4.6%. From this range the commission got:

    - an average of 15.7%
    - a median of 14.7%
    - 25th percentile of 11.4%
    - 75th percentile of 19.2%.

28. The commission reached the view that a mark-up of 17.2% equates from the median of 14.7% (i.e., 14.7%/(1-14.7%) = 17.2%).[5]

29. We question the appropriateness of the original bench marking exercise on the basis that: the 12 contracting companies used were too dispursing and no New Zealand contracting companies were used in the benchmarking.

30. The commission has expressed the view that the arguments given to date are not sufficient to justify a change to the threshold as the commission based this rate on external benchmarking.[6] We disagree and are of the view that our experience clearly supports a review of the method used by the commission to set the threshold as part of the wider IMs review.

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[4] Commerce Commission, *Information Disclosure for Electricity Distribution Businesses and Gas Pipeline Businesses: Final Reasons Paper*, 1 October 2012, paragraphs E30 to E34.

[5] Supra n4, paragraph E34.

[6] Supra n4, paragraph 3.52.

31. Accordingly, we recommend that as part of the IMs review the commission review the method used to set the 17.2% threshold.

A review of the eight options is recommended

32. We are of the view that the eight options are not practical as the framework is in its infancy and the wording of the options assumes that we are further along in the framework.

33. For example, options (c) and (f) assume that EDBs were keeping records or having valuations done before the IMs came into effect. Is the requirement to have seven years of records in a manner that complies with a framework that is less than seven years old appropriate or effective?

34. We support the commission's need to demonstrate that prices paid to related parties are not being used to over inflate the RAB, but we question whether the wording of the current eight options and appropriate is effective in meeting this intention.

35. Accordingly, we recommend that the commission review whether the eight options might be added to and/or amended.

Simple fixes are also important

36. Submitters have made the commission aware of a number of simple fixes that should be made to the IMs in previous consultations.[7] We are of the view that this review is the opportune time to make those necessary corrections and clarifications.

37. We appreciate that the commission has finite resource and time and that the temptation is to concentrate on the 'big issues' and put these simple fixes to one side. We urge the commission not to give into this temptation as the simple fixes are also important.

38. We also have finite resources and time constraints. There have been many times where we have had to spend time and commit resources to rereading, clarifying, and reinterpreting IMs simply because of a small seemingly immaterial error or a lack of clarity. This is time in our view that is wasted and could have been better used on other more beneficial projects such as consumer engagement and pricing strategies.

39. Accordingly, we recommend that the commission commit to making the time to

[7] For example, PwC, *Submission to the Commerce Commission on Proposed amendments for 2015 to information disclosure determinations for electricity distribution and gas pipeline services*, 19 December 2014, and PwC, *Submission to the Commerce Commission on Amendments to information disclosure requirements – proposed process*, July 2014, and PwC, *Submission to the Commerce Commission on Commerce Act (Electricity Distribution Services Information Disclosure) Determination 2012 – Review of Spreadsheet Templates Issued for Technical Consultation*, 17 August 2012.

progress the simple fixes that have been brought to its attention at other consultations to correct for errors and to provide much needed clarity.

Closing remarks

40. We hope that our submission is helpful to the commission in the scoping of the problem definition for the purposes of its review of the input methodologies. We are happy to discuss our opinions further with the commission if it would be of benefit.

41. The main contact for this submission is:

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Appendix A

Options for valuing commissioned assets from a related party

42. If we are determining the value of a commissioned asset or costs associated with a commissioned asset acquired from a related party, then Clause 2.2.11(5) of the IMs allows us eight options to choose from. Each option is described below.

    i) 2.2.11(5)(a)—the cost of all assets acquired from the related party are less than 1% of the opening regulatory asset base (RAB); or less than 20% of all assets commissioned in the year in question.

    ii) 2.2.11(5)(b)—at least 50% of the related party's assets are to third parties and third parties can purchase the same or substantially similar assets from the related party on substantially the same terms and conditions—including price; or the price paid by Alpine is the same as the price paid for similar assets over the last three years from a third party.

    iii) 2.2.11(5)(c)—if a competitive tender has been undertaken then: the price from a related party is no more than 5% higher than the lowest conforming tender; all relevant information was provided to a third party; one other proposal was received; and we have kept records for seven years on the criteria used to assess tenders.

    iv) 2.2.11(5)(d)—the related party transaction can be valued as the depreciated historic cost of the commissioned asset on the day before the transaction took place using GAAP.

    v) 2.2.11(5)(e)—the related party transaction can be valued as the inventory value of the commissioned asset on the day before the transaction took place using GAAP.

    vi) 2.2.11(5)(f)—the related party transaction can be valued as the market value at commissioning date as determined by a valuer.

    vii) 2.2.11(5)(g)—the related party transaction can be valued as the directly attributable cost incurred by the group using GAAP.

    viii) 2.2.11(5)(h)—if none of the options above can determine price then two or more directors can sign and affirm the value of a related party transaction reflecting the price that would be received in an arm's length transaction.

    ix) 2.2.11(5)(i)—the related party transactions were nil during the year.

Our evaluation of the eight options

43. Table 1 below lists options one to eight (from clause 2.2.11(5)(b) and shows whether, or not, each option is realistic as a method for us to price related party transactions.

Table 1 Options available to us

Option		Realistic to employ	Reason why/why not
i)	2.2.11(5)(a)	No	Asset additions in the last three years have been greater than the 1% and 20% thresholds allows.
ii)	2.2.11(5)(b)	No	Less than 50% of NETcon sales are to third parties. Over the last three years approximately 95% of NETcon sales have been to us.
iii)	2.2.11(5)(c)	No	We do not have records for seven years of competitive tender proposals including reasons for accepting proposals. This may be an option after 2019.
iv)	2.2.11(5)(d)	No	NETcon do not sell us commissioned assets it sells us contracting services. Adopting this approach would result in the determination of a less than cost reflective price.
v)	2.2.11(5)(e)	No	We do not keep financial records using the inventory value method. This would require a fundamental change in how we keep our records.
vi)	2.2.11(5)(f)	No	The cost to employ an external evaluator is cost prohibitive.
vii)	2.2.11(5)(g)	No	While we have financial records which show directly attributable costs the 17.2% threshold means NETcon would undercover its costs from us if we were to use this option.
viii)	2.2.11(5)(h)	Yes	But only because we cannot use any of the above options.
ix)	2.2.11(5)(i)	No	NETcon is our contractor and so, provided we do work on the network, there will be related party transactions.