COMMERCE COMMISSION NEW ZEALAND

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Electricity and Gas Input Methodology Determination Amendments (No. 1) 2012

Reasons Paper

Amendments to Decisions 710, 711, and 712 under s52X of the Commerce Act 1986 to the treatment of asset valuations in related party transactions in the information disclosure and customised price-quality path input methodologies applicable to electricity and gas distribution businesses, and gas transmission businesses.

Date: 29 June 2012

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Section One: Introduction

Purpose

1. This paper sets out our final decisions on amendments to the input methodologies for electricity lines services and gas pipeline services. A notice of intention was given on 19 April 2012, and draft versions of these amendments were consulted on as part of our 11 May 2012 consultation paper.[1]

We have amended three input methodologies determinations

2. The input methodologies that we have amended are contained in the following determinations:

    - *Commerce Act (Electricity Distribution Services Input Methodologies) Determination 2010* (Commerce Commission Decision 710, 22 December 2010)

    - *Commerce Act (Gas Distribution Services Input Methodologies) Determination 2010* (Commerce Commission Decision 711, 22 December 2010)

    - *Commerce Act (Gas Transmission Services Input Methodologies) Determination 2010* (Commerce Commission Decision 712, 22 December 2010).

3. The suppliers affected by the amendments are referred to in this paper as electricity distribution businesses (EDBs), gas distribution businesses (GDBs) and gas transmission businesses (GTBs).[2]

Our decisions relate to two specific methodologies

4. Our decisions on amendments relate to the following methodologies:

    - Asset valuation for information disclosure and customised price-quality paths—we have modified the treatment of asset acquisitions by EDBs, GDBs, and GTBs from related parties.[3]

    - Disclosure years for GDBs and GTBs—we have not made any amendments in respect of the 'disclosure year' for suppliers of gas pipeline services. Instead, we will define disclosure years as part of information disclosure determinations. With the exception of Powerco, disclosure years will be based on each supplier's current financial year-end. Powerco's disclosure year will be based on a September year-end.

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1 Commerce Commission, *Consultation on Electricity and Gas Input Methodology Determination Amendments 2012*, 11 May 2012.

2 The input methodologies for Transpower New Zealand Limited, which supplies electricity transmission services, are not contained in the Part 4 input methodologies determinations listed in paragraph 2 and are not subject to these amendments.

3 Asset valuation input methodologies for default price-quality paths for are being determined separately: http://www.comcom.govt.nz/additional-input-methodologies-for-electricity-and-gas-dpps/.

Structure of the remainder of this paper

5. We have structured the remainder of this paper as follows:

    - **Section Two**: Final decisions on modifications to the value of asset acquisitions by EDBs, GDBs and GTBs from related parties.

    - **Section Three**: Final decisions on disclosure years for suppliers of gas pipeline services.

6. Amendment determinations and consolidated versions of the amended Decisions 710, 711, and 712 are available on our website.[4]

[4] *Electricity and Gas Input Methodology Determination Amendments (No. 1) 2012* can be found at http://www.comcom.govt.nz/correspondence-and-process-updates/ and the input methodologies webpages for each of the relevant services.

Section Two: Final decisions on treatment of related party asset acquisitions

Overview

7. We have amended the treatment of related party asset acquisitions to provide additional methods for suppliers to establish that these transactions reflect 'arm's-length' equivalent values. The new rules provide greater flexibility for suppliers to address individual circumstances, while continuing to ensure that the arm's-length nature of the transactions is supported by objective criteria.

8. These amendments apply to the input methodologies for EDBs, GDBs and GTBs in respect of information disclosure and customised price-quality paths.[5]

Rationale for making an amendment

9. The input methodologies published in December 2010 included rules to ensure that the regulatory value for assets acquired from related parties reflected the outcomes that would be produced in workably competitive markets.[6] This recognises that while related party transactions may produce efficient outcomes, a degree of oversight is required as related party transactions can also be subject to manipulation.[7]

10. To reflect outcomes that occur in workably competitive markets, the input methodology requires an 'arm's-length' approach to valuation rather than accepting unscrutinised acquisition prices.[8] Two options were available for suppliers to certify transactions at arm's length; the depreciated historic cost determined by applying GAAP; and the market value at commissioning date as determined by a valuer.

11. Following requests from parties to expand this list,[9] we have consulted on, and amended, the relevant input methodologies. Our decision provides additional methods that can be used to provide assurance of the arm's-length value of related party asset acquisitions. All of the options rely on the existence of objective and verifiable information (for example, confirmation of previous outsourcing arrangements or a competitive tender process) to support the value for the transaction.

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5 We note that the existing input methodologies for customised price-quality paths reflect the same requirements as those for information disclosure regulation, with modifications to accommodate the 'forecast' nature of asset values.

6 That is, consistent with the purpose of Part 4 of the Commerce Act.

7 Where a supplier of electricity distribution services or gas pipeline services purchases an asset from a related party—or sells an asset to a related party—the value at which the asset is transferred is open to manipulation. The presumption is that transactions with a related party are not arms' length transactions. Without the discipline of an arms' length negotiation the price paid may be greater (or less) than the asset's market value. This could create a transfer of wealth between the EDB or GPB and consumers that would not occur in a workably competitive market.

8 We have continued to use the principle of arm's length transactions to guide our decisions on making amendments to the relevant input methodologies for related party transactions. The definition of 'arm's length' is set out in clause 1.1.4(2) of each of the relevant input methodology determinations.

9 For example: Unison, *Re: Treatment of transactions between related parties*, 24 January 2011.

Multiple options for determining the value of related party asset acquisitions

12. Where a supplier can provide evidence to support one of the options provided, the acquisition value is determined in accordance with the terms of that option under generally accepted accounting practice (GAAP). Consistent with this, assets acquired from a related party may enter the regulatory asset base at:

    a. the price paid by the EDB to the related party, 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 opening regulatory asset base value in that disclosure year, or 20% of the cost of all assets commissioned by the regulated supplier in that disclosure year

    b. the price paid, where

        i. the related party makes at least 50% 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, or

        ii. the type of asset (or group of assets) in question has previously been acquired by the regulated supplier from an unrelated party within the last three years and the price paid was the same or less than the cost incurred under the previous arrangement

    c. the price paid, where a competitive tender process has been used by the regulated supplier and the asset (or group of assets) was acquired at a value equal to, or within 5%, of the lowest conforming tender price (subject to certain document retention requirements)

    d. 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

    e. in respect of material asset components, a cost limited to the inventory value of the asset in the books of the related party. This is determined by applying generally accepted accounting practice on the day before the acquisition by the regulated supplier

    f. a cost limited to the market value of the asset as at its commissioning date as determined by a valuer

    g. the directly-incurred cost to the 'group' to which the supplier and related party belong that would arise under GAAP if the supplier were consolidated into the group for regulatory purposes. Any intra-group charges used to determine direct costs to the related party (which are not eliminated as profits on consolidation) should be attributed in accordance with the cost allocation input methodology, and we expect would otherwise be the costs disclosed by the supplier under any applicable information disclosure determination

h. where no other approaches are appropriate, the price paid, where directors certify that they are satisfied, having considered any relevant information, that the price charged to the regulated supplier for the asset is equivalent to an arm's-length price.

13. In all other cases, the asset acquisition value will be recorded for regulatory purposes at 'nil' value. We consider it inappropriate to include asset acquisitions in the regulatory asset base that arise from related party transactions for which there is insufficient evidence to demonstrate arm's-length value outcomes. To hold otherwise could provide perverse incentives for suppliers to artificially inflate asset values and undermine the purpose of Part 4.

Related asset acquisitions in CPP proposals

14. For the purposes of making CPP proposals, suppliers are required to provide directors' certification for the arms-length equivalent forecast price for future related party asset acquisitions.[10] Only one certification is required for all related party asset acquisitions included in the CPP proposal.

15. We consider directors' certification appropriate as forecast information used for future related party asset acquisitions is likely to be at the aggregate level which means it is difficult to apply to the above options (a) to (g) with any certainty; and it is likely to be difficult to predict where assets are to be acquired from year to year (whether from a related party or otherwise).

16. Whilst all CPP proposals are subject to directors' certification, we consider a specific directors' certification is required for related party asset acquisitions as by their nature they may not reflect arm's length transaction costs.

17. Directors should however, use the forward application of options (a) to (g) as reasoning in their certification of future related party asset acquisitions, and we encourage them to do so. For example, where a related party asset acquisition has occurred in the past under options (a) to (g), and a similar acquisition is forecast, directors may wish to use the previous acquisition as evidence.[11]

Our decision provides a balance of options

18. Aurora and Orion raised concerns with some of the individual options available, indicating that they would not suit their particular circumstances, or the circumstances of some other suppliers.[12] We acknowledge that each option may not suit all circumstances, but consider these options may still be applicable to other suppliers. The

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10 This certification is essentially the same as option (h) above, but on a forward looking basis. That is, to the best of the director's knowledge, the related party transaction to occur will be conducted as if at arm's length.

11 Where there are no previous related party asset acquisitions to support certification for future related party asset acquisitions, known factors that would make options (a) to (g) applicable in the future could be considered reasonable justification.

12 Aurora, *Submission to the Commerce Commission on its Draft Amendments to Decisions 710 under s52X of the Commerce Act 1986*, 1 June 2012, page 3; and Orion, *Submission on Electricity and Gas Input Methodology Determination Amendments 2012*, 1 June 2012, page 3.

intent of providing multiple options was not so that every option would be appropriate for every supplier all of the time, but so that each supplier would have a reasonable array of options available to it.

19. We consider our decision provides a balance of options, and note that where a related party transaction does not comply with any of the other categories, suppliers still have the option of certifying that a related party transaction is consistent with arm's-length outcomes. Director's certification is discussed further in paragraphs 22-24.

We have used thresholds to help determine the appropriate valuation method

20. We have used thresholds to help determine the appropriate regulatory value of assets acquired by regulated suppliers from related parties.[13] These thresholds are to ensure that the effort required to provide assurance over an arm's-length equivalent valuation is commensurate with the materiality of the amounts involved.

21. Specifically, the thresholds in option (a) recognise that some suppliers may acquire a small enough value of assets from related parties that examining specific documentation to establish arm's-length prices is not warranted. In these cases, we are satisfied that the overall impact of the transactions is sufficiently small that it would not be contrary to the long term-benefit of consumers to adopt the acquisition price. The threshold values we have chosen reflect our view of materiality considerations that would be applied by consumers and other users of disclosed information.

22. The threshold in option (b) represents our view that if a significant enough percentage of the related party's transactions are made with unrelated parties, then the prices in these transactions are likely to approximate prices in workably competitive markets. That is, unrelated parties have sufficient market power to negotiate prices which are close to being workably competitive and these can be used as an arms-length benchmark for prices charged to the supplier.

Option to use Director's certification

23. Option (h) allows suppliers to use price paid, where directors certify that they are satisfied, having considered any relevant information, that the price charged to the regulated supplier for the asset is equivalent to an arm's-length price.

24. At a minimum these directors' certifications must be based on a reasonable belief of the directors, considering the information reasonably available, that the transaction is equivalent to a price that would be achieved in an arm's-length transaction as defined in the relevant input methodologies determination.[14]

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[13] Thresholds are used in overseas jurisdictions for the valuation of related party transactions. For example, Ofgem, *Electricity Distribution Price Control Review Final Proposals - Financial methodologies, 7 December 2009*, page 8.

[14] In drafting the methodologies, we have made use of the existing definition of 'arm's-length transaction' which is contained in clause 1.1.4(2) of each of the relevant input methodology determinations.

25. We clarify that only one certification is required where a group of assets is acquired over time but within a disclosure year, ie, directors need not individually certify each asset acquired but can do so as a group.

Modifications from our draft decision

26. Our final decision reflects our draft proposal with some modifications in light of further consideration of the issues at hand, and the views of submitters. We have adopted the following substantive changes following consideration of submissions:

    a. adoption of a new "group cost" approach proposed by parties

    b. reduction of the 75% external transaction threshold for related parties to a 50% threshold

    c. inclusion of a threshold for comparing related party's price to no more than 5% above the lowest tender price

    d. director's certification no longer required for some options.

New option – 'group cost' approach

27. PwC suggested an alternative option to 'nil value' stating:[15]

> *The default option should be the directly incurred cost to the related party. This can be defined as the costs incurred by the Group to which the EDB and related party belong, by applying GAAP (ie: it eliminates any margin included in the transaction cost over and above direct cost). This would ensure that those EDBs which have adopted commercial structures by establishing their cost construction related services as subsidiary or commercial entity are treated at least the same as those which have maintained the services with the EDB. To do so otherwise would penalise the former arrangement (by ascribing nil value to the assets constructed by the related party) relative to the latter arrangement (by ascribing cost to assets constructed by the EDB).*

28. We consider this approach to be reasonable and have included option (g) to allow asset acquisitions to be valued at 'group cost.' However, we have not included the group cost option as an alternative to the nil value. As set out in paragraph 13, we still consider nil value is appropriate for transactions that cannot be justified under any of the options available (and by including the group cost approach suppliers should have even less reason to be in a position where a nil value is applied).

29. For the group cost option, we clarify that the direct cost to the group is the direct cost that would be recorded under GAAP if the regulated supplier and the related party were a consolidated group for regulatory purposes. To the extent that any intra-group charges are not eliminated as profits on consolidation then they must both be costs that would otherwise be incurred by an EDB and attributed in accordance with the cost allocation methodology. This situation might occur, for example, where a management fee to

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[15] PwC, *Submission to the Commerce Commission on Consultation on Electricity and Gas Input Methodology Determination Amendments 2012*, 1 June 2012, page 11.

recover head office labour costs is charged to a related party contractor and used as a basis for determining direct costs to the related party contractor.

Reduction of 75% threshold for transactions that are with related parties to 50%

30. Option (b) now allows suppliers to use the price paid where the related party makes at least 50% 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.

31. We had previously proposed a threshold of 75%, but have reduced the threshold to 50% in our final decision after consideration of submissions.[16] Some submitters suggested that 75% was a high threshold to meet, and it could potentially require an undue amount of the related party's transactions to be made via other EDBs—which in some circumstances would be impossible.[17] To make this a more viable option for suppliers, we have therefore lowered the threshold.

Inclusion of a 5% threshold for lowest tender price

32. Option (c) now allows suppliers to choose a tender that is within 5% of the lowest price where they would have otherwise been required to accept the lowest price in the draft proposal.

33. We have included the 5% discretionary band after consideration of submissions which[18] asserted that there may be good commercial reasons not to accept the lowest tender price. We agree with this view and consider 5% sufficiently allows suppliers to take account of non-price considerations when making asset acquisitions through competitive tenders. It also retains an appropriate focus on minimising costs consistent with workably competitive markets.

Director's certification no longer required for some options

34. In our May 11 consultation paper, we originally proposed that directors' certification be provided for each transaction determined in accordance with the options (b) and (c) above.[19]

35. Following submissions, we consider that certifications are not necessary where deemed costs or prices paid are supported by evidence to show the criteria for the relevant option are met. As set out above in paragraphs 19-21, we have decided to require directors' certification only for those transactions where other options are not available and suppliers wish to record asset acquisitions at the price paid.

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16 For example: Orion, *Submission on Electricity and Gas Input Methodology Determination Amendments 2012*, 1 June 2012, page 3.

17 For example: Aurora, *Submission to the Commerce Commission on its Draft Amendments to Decisions 710 under s52X of the Commerce Act 1986*, 1 June 2012, page 3.

18 For example: Orion, *Submission on Electricity and Gas Input Methodology Determination Amendments 2012*, 1 June 2012, page 3.

19 The form of the directors' certification will be prescribed in an ID determination. This will allow the form of the certification to be updated in minor ways from time to time to meet the practical needs of regulated suppliers and interested persons.

Section Three: Final decisions on 'disclosure year' for gas pipeline services

Overview

36. We have decided against amending the relevant input methodologies determinations to specify regulatory disclosure years for GDBs and GTBs.

37. We had proposed that a single common disclosure year (from 1 October to 30 September) apply from the start of the Part 4 regulatory regime.[20] This would have aligned with the 'pricing year' for most gas business customers.

38. We will define disclosure years for GDBs and GTBs in our information disclosure determinations under s 52P, as the 12 month period ending:

    - 30 September for Powerco
    - 30 June for Vector and GasNet
    - 31 December for MDL.

39. We will finalise the information disclosure determinations in August 2012, and will release revised drafting shortly for technical consultation.

Decision not to amend disclosure years

40. Our proposal to amend disclosure years for gas pipeline services assessed disclosure years in light of implementing a new regime for gas pipeline services.[21] With the information available at that time, we considered on balance that aligning all suppliers to a single disclosure year was appropriate. Namely that alignment would:

    - make it easier for interested persons to assess overall sector performance, as the data disclosed for different businesses would be more comparable
    - avoid having an inconsistent time-series if a GPB decides to change their financial year (as Powerco has done) in future periods
    - potentially reduce long-term compliance costs for suppliers as at least some of the information disclosed under information disclosure could be used for default price-quality path compliance purposes.[22]

41. Submissions from MDL, Vector and GasNet all opposed a disclosure year that differed from their respective financial years, whilst Powerco supported our proposal.[23] The

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20 Commerce Commission, *Consultation on Electricity and Gas Input Methodology Determination Amendments 2012*, 11 May 2012, pages 11-16.

21 More specifically, this follows that input methodologies were required to be determined in advance of further work on the Part 4 regime for gas pipeline services, including the development of summary and analysis for information disclosure, and default/customised price-quality regulation. The development of this further work informed our proposal to amend to disclosure year.

22 In addition, information would be available over time that could be aligned with pricing years for default price-quality paths (although this is dependent on the outcome of consultation on gas default price-quality paths).

opposing submitters all cited that there would be a significant increase in on-going costs by aligning disclosure years at 1 October, as suppliers were unlikely to change their financial years to match. Where disclosure years and financial years do not match suppliers are required to produce two sets of audited information each year, incurring a second set of audit costs. Powerco supported our position as their six monthly reporting period would align with the 1 October date, meaning minimal additional audit costs.

42. Despite the benefits of an aligned approach (as set out in paragraph 39), we currently consider that, on balance, it is more appropriate for suppliers to be allowed to remain on varied disclosure years at this point in time.

43. However, we consider the cost and benefits of a single disclosure year finely balanced, and recognise that there are substantial benefits to an aligned disclosure year.[24] In addition to the reasons previously set forth, we note that if GDBs and GTBs are on different disclosure years this will make calculation of starting prices more difficult. Specifically, to calculate starting prices we will need to make an adjustment to information to bring it into line with the regulatory period.

44. We therefore will continue to assess the benefits of a common disclosure year, and if new information comes to light, we remain open to reconsidering disclosure years in the future.

Accommodating regulatory asset base roll-forward for varied disclosure years

45. As disclosure years for suppliers will vary, the current input methodologies specification of RAB roll-forward—which is applied across a full 12 month period ending 30 June—will need to take account of partial disclosure years. Namely, we are considering an amendment to take account of the three month period between 30 June and 30 September for Powerco, who is to disclose on a 30 September basis.

46. This would ensure that Powerco can roll forward the value of its regulatory asset base accurately in shifting to a different disclosure year, and will provide sufficient flexibility to allow for partial year roll-forwards should the need arise.

47. We intend to consider this amendment as part of a separate process, in advance of April 2013, when suppliers make their first disclosures under the new information disclosure regulations.

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[23] GasNet, *Submission on Proposed Amendments to Input Methodologies*, 30 May 2012; MDL, *Submission to the Commerce Commission for the Consultation Electricity and Gas Input Methodology Determination Amendments 2012*, 1 June 2012; Powerco, *Powerco submission on Input Methodology Determination Amendments*, 29 May 2012; Vector, *Consultation on Electricity and Gas Input Methodology Determination Amendments 2012*, 1 June 2012.

[24] Commerce Commission, *Consultation on Electricity and Gas Input Methodology Determination Amendments 2012*, 11 May 2012, pages 11-16.

Attachment A: How to apply related party transaction in practice

48. To illustrate how the options for related party transactions might be applied for information disclosure, we have set out the practical implications of our decision in the diagram below.

Diagram 1: An example of how related party transaction criteria might be applied in practice for information disclosure