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Dear Keston,

Vector submission on the Review Related Party Transactions Review Draft Decision

1. This is Vector's submission to the Commerce Commission's (Commission) Input Methodologies (IM) Review Draft Decision on Related Parties Transactions (RPT). No part of this submission is confidential and we are happy for it to be publicly released.

Key recommendations from Vector

2. The Commission should consider:
 - a *de-minimis* threshold for the application of the RPT rules to ensure it achieves the right balance between consumer protection and the cost burden for more onerous compliance requirements;
 - removing the new information requirements (i.e. maps) for asset management plans (AMPs) to limit disproportionate accretive regulation of limited benefit to the problems identified with RPT;
 - its power to apply obligations on referrals by suppliers as this new requirement appears beyond the scope of Part 4 of the Commerce Act (the Act);
 - the unintended consequences for management decisions for the publication of procurement policies and the requirement for director certification; and
 - greater disclosure around inter-company loans to develop a greater understanding of the relationships suppliers have with their company peers and whether this provides any insight into the connection the supplier has with their customers and New Zealand.

The Related Party Transaction rules

3. The RPT rules are intended to require a supplier to demonstrate its insourced inputs are provided on arm's length terms reflecting market rates. Accordingly, the RPT rules allow the supplier to select the most efficient combination of insourced and outsourced inputs for providing the regulated service. The RPT rules also cover transactions from the supplier to a related party.
4. Discharging the requirements of the RPT rules is intended to provide comfort for the Commission and interested parties that the RPT is not resulting in inflated terms for the related party service.

The problem definition

5. The Commission has observed a growing volume and value of RPT among regulated suppliers. The growing volume of RPT could be harming consumers of the regulated service if the growth is being caused by suppliers seeking to increase their overall profit by overcharging for their related-party input or selecting their related party provider when they are not the most efficient supplier.
6. The Commission found the policy behind the RPT rules remains appropriate. However, it is concerned the application of the current rules could be frustrating their purpose due to possible flaws in the current design.

The proposed changes – replacing the current RPT rules with a general valuation rule

7. The Commission has proposed replacing the current RPT rules in the Information Disclosure (ID) Determination for operating expenditures and the IM Determination for commissioned assets with a general market valuation rule.

Recommend a de-minimis threshold for application

8. We recommend the Commission apply a *de-minimis* threshold for application of the RPT rules and disclosure requirements. The cost of having low value transactions subject to the disclosure requirements and the general valuation rule will increase the administrative burden and costs for compliance and outweigh any benefit to be gained. A *de-minimis* threshold also provides a clear protection for the customer from having inflated costs included in the regulated service price.

9. The evidence gathered by the Commission of a problem with RPT was the growing value and quantum of transactions. Therefore, a *de-minimis* threshold would provide the right incentive for suppliers to limit their volume of RPT.
10. Moreover, where a supplier is subject to a constraint such as an imperfect local market for contracting services requiring it to exceed the *de-minimis* threshold then it should be able to demonstrate the use of a related party contractor is occurring on arm's length terms reflecting market rates. This is the type of transaction the RPT rules are intended to provide certainty about – that significant transactions are being executed for efficiency reasons and not as a means of increasing costs for the regulated customer.
11. The Commission's requirement for suppliers to provide examples where an expenditure exceeds 10% of the supplier's total related party expenditure highlights the value of having a *de-minimis* threshold.¹ As currently drafted this new obligation will require suppliers to provide examples about very low value transactions.
12. To ensure the compliance obligations involved with the RPT changes are proportionate we recommend a *de-minimis* threshold that provides reasonable protection for customers.

Recommend removing the actual cost – value limit

13. The new general valuation rule includes a limb which requires the actual cost of the transaction to be used if the RPT is found to be below arm's length terms. We have some concern about the Commission's requirement for the actual cost where the RPT is found to be below arm's length terms.
14. Given the Commission's problem definition is founded on a concern about suppliers engaging in RPT above market terms. We find it counter-intuitive that suppliers must submit actual costs if their RPT are in fact below the market.
15. This will ultimately result in such costs being calibrated at the resetting of a regulatory period (for a price-quality regulated business) at below the market rate. The consequence of such an outcome is that it will ultimately "lock out" the market. Therefore, we recommend the Commission reconsider this limb of its general test.

¹ Proposed clause 2.3.9 (5) *Electricity Distribution Information Disclosure Amendments Determination (No. 2) 2017*

The proposed changes – new information requirements to produce maps for AMPs

16. We find this proposed obligation fails the test of proportionate regulation and should not be considered in the context of the RPT rules. The requirement for a supplier to produce more information in its AMP namely a map of anticipated network expenditures for operating expenditure and capital expenditure including timing, value and location merely because it has disclosed a RPT is creating ill-fitting accretive regulation.
17. We find it unreasonable that such a “catch all” solution is imposed irrespective of the nature of the RPT. Given a significant portion of related party relationships are for field force service providers doing routine maintenance, it is very difficult to understand how the proposed new information will be helpful or possible for non-related service providers. It will be very difficult for a supplier to forecast where and when cross-arms, poles or conductors will require replacement. Moreover, such related party relationships are not defined by network constraints. Therefore, it is not apparent how non-related party field force suppliers would be better served with information about network constraints when their business is more involved than dealing with network constraints.
18. As an example of the perverseness of the “catch all” requirement, for Vector we only have a small volume of RPT but do have a relationship with our vegetation service provider and anticipated little impact from the changes to the RPT rules. However, under the proposed rule, we must significantly amend our AMP to disclose on a map where such vegetation expenditure is expected to occur. Given the nature of vegetation management, the mapping of such expenditure will be virtually impossible and of limited utility to any interested party. The further requirements to disclose on a map information about our capital program due to the relationship with our vegetation service provider highlights the perverseness of the requirement given the related party relationship has very little association with our capital program.
19. Accordingly, the new information requirement applies much broader obligations for information than RPT services and will only apply to suppliers that have an RPT. Therefore, some suppliers must produce an AMP with the additional information requirements while other suppliers will not have such an obligation. We find this piecemeal obligation across suppliers to be discriminatory.
20. According to the Commission “this proposal is supposed to support suppliers of the regulated service by enabling third-party providers to potentially provide cost effective

(potentially non-network) solutions.”² This objective has very little association with RPT but instead is seeking to create more opportunity for alternative solutions (including third party options) for assisting with network management.

21. The Commission appears to have an expectation the information will result in more third party solutions on networks. However, it has not consulted with industry beforehand to consider whether the new obligation will further this objective. Indeed, it is possible many suppliers will have agreements on foot for their network service. Therefore, the production of more information may not deliver the Commission’s objective but will increase the information burden on suppliers.

The proposed changes – requirements on referrals by the regulated supplier to a related party supplier

22. The Commission included in its draft decision a requirement for the supplier to describe any procedures and technical standards the supplier uses when referring a customer to a related party service supplier.
23. We are concerned this obligation is unconnected to the matters raised in the Commission’s problem definition for RPT. Further, the obligation also derogates from the Commission’s standard for making changes to the RPT rules – namely the change will promote the Part 4 purpose in section 52A and promote the IM purpose in section 52R.
24. A referral by the supplier to a related party supplier does not result in the customer paying any more for the regulated service. Rather, a referral to a related service or good is merely conveying information to the customer. This type of activity is common across the economy and generally perceived to have no detriment to the customer. For example, it is common for a broadband provider referring its customers to its related retail energy business or a mobile service provider recommending its related fixed broadband service. This type of information is generally recognised as being constructive for empowering customers to make the best purchasing decisions for their needs.
25. Accordingly, we are concerned the Commission is imposing a requirement that deviates from its statutory mandate under section 52A of the Act and could be considered beyond the limits of its power under Part 4 of the Act.

² Commerce Commission, *Input Methodologies Review Draft Decision – Related Party Transactions Draft Decision and Determinations Guidance*, 30 August 2017, p. 67

26. Where the Commission is concerned about suppliers unfairly preferring their own related party business or creating unfair barriers for a competitor, the Commission already has the tools to address such unfair behaviour.

The proposed changes – publication and certification of procurement policies

27. The Commission will require suppliers who have disclosed RPT to also publish a summary of their procurement policy, and have their directors certify the procurement policy is being applied.
28. We do not support the publication of a summary of the procurement policy or having director certification. The requirements have the potential to create more mischief for the supplier than benefit for customers. Supplier procurement policies have applicability beyond RPT. Therefore, the publication of such information will have an interested audience beyond the scope of stakeholders interested in the RPT rules and competitors of a related party service.
29. As discussed in our submission to the Commission's Invitation to Comment on the Problem Definition there are a range of subjective considerations for management relevant when selecting a preferred partner such as related intellectual property, willingness to accept risk, shared philosophy (i.e. sustainability commitment) or ties to the local community and New Zealand. Some of these considerations may affect procurement outcomes and are an exercise of the skill and judgement of management.
30. The proposed changes for procurement policies have the potential of significantly limiting management decision-making. An example of how this limitation will occur is where the supplier has identified a partner for a new service, such as LiDAR an innovation in network management, with the potential to provide immediate benefits for reliability management. The supplier may have a desire for speed to implement the new service and selects a partner (not a related party) for delivering this service based on a shared history and understanding of delivery and knowingly bi-passes its procurement policy.
31. In the above example the supplier will not be able to comply with the RPT rules around the procurement policy due to its decision to prioritise the speed to implement the LiDAR service on the network. In this instance, the non-compliance will be driven by a matter unrelated to the RPT rules and problems identified by the Commission.
32. The proposed changes to include procurement policies as part of the RPT rules will significantly extend the scope to a significant volume of transactions not intended to be

captured by the RPT rules. Accordingly, the proposed changes will impede on management decision-making with very little benefit for achieving the RPT rules purpose.

Proposed changes – other issues

Drafting issues

33. We do have some concerns with the Commission's new proposed general rule which uses different sources for referencing key defined terms. We see problems with the Commission relying on audit standard definitions, accounting standard definitions and its own definition for other defined terms.
34. For instance, we note the definition of 'related party' relies, in part, on an accounting standard, the definition of 'arm's length transaction' is defined by the auditing standard and the definition of 'related party transaction' does not follow either an accounting or auditing standard despite the term being defined by these standards. The use of different sources will cause confusion and complexity.
35. Given the IMs are generally based on accounting standards it is reasonable for any referenced definitions to rely on such standards.

Improving transparency for public benefit could include related party financing

36. If the Commission is minded to consider amendments to the RPT rules based on deriving a public benefit irrespective of whether the benefit is related to the Part 4 purpose, then it should consider creating greater transparency around related party inter-company loans. We believe there is a public benefit from having greater transparency around related party inter-company loans among suppliers.
37. Greater disclosure around inter-company loan arrangements would provide an opportunity for interested parties to get a greater understanding on the terms upon which the supplier contracts with their related company peer and whether they can earn a reasonable commercial profit from such arrangements. This could illuminate how connected suppliers are to customers and to New Zealand. The disclosure of related party loans is consistent with related parties accounting standard disclosure requirements.

Conclusion

38. We appreciate the effort the Commission has undertaken to understand the issues relevant to the RPT and uncover the problems with the existing rules. We encourage the

Commission to adhere to its framework for considering changes to the existing RPT rules and the threshold it has set for making changes.

39. We recommend the Commission consider the compliance burden involved with its changes. In this regard, we consider a *de-minimis* threshold is an effective means of limiting the burden of compliance but also providing sufficient protections for the customer.
40. We caution against arbitrary changes such as those proposed for the AMP without having the debate in the correct forum to allow appropriate discussion about the merit, costs and benefits of change. To discuss any questions in relation to this submission please contact Richard Sharp on Richard.Sharp@vector.co.nz or on 09 978 7547.

Yours sincerely
For and on behalf of Vector Ltd

A handwritten signature in blue ink, appearing to read "Richard Sharp".

Richard Sharp
Head of Regulation and Pricing