



COMMERCE COMMISSION INPUT METHODOLOGIES REVIEW

RELATED PARTY TRANSACTIONS Invitation to contribute to problem definition

17 MAY 2017

Electricity Retailers' Association of New Zealand
PO Box 25596, Featherston Street, Wellington, 6146

1. Introduction

- 1.1 The Electricity Retailers Association of New Zealand (ERANZ) welcomes the opportunity to submit on the Commerce Commission's (the Commission) Input Methodologies review of Related Party Transactions Problem Definition paper (the paper).
- 1.2 ERANZ was established in August 2015 to promote and enhance an open and competitive electricity market that delivers value to New Zealand electricity consumers.

ERANZ represents Genesis Energy, Contact Energy, Mercury, Meridian Energy, Trustpower, Nova Energy, Pulse Energy, Prime Energy, Powershop, Black Box Power, Bosco, Energy Online, Just Energy, King Country Energy, Globug, Grey Power Electricity, Electra Energy, and Tiny Mighty Power, equating to around 98.5% of the market by ICP count.

New Zealand's electricity market conducts \$7 billion worth of transactions every year. Electricity retailers are the first point of contact for electricity consumers, comprising over 1.7 million New Zealand households and businesses.

2. Scope

- 2.1 ERANZ's understanding from this paper, and our meeting with the Commission on 27 April 2017 is that the Commission is specifically seeking feedback on:
 1. Their definition of the issues involving the operation of related party transactions.
 2. The efficacy of their initial views on potential solutions.
- 2.2 Our submission is focused on these two points. However, we do also make comment about the wider context which adds weight to why a review of related party transactions is particularly important at this juncture. Some of these points were raised by ERANZ in our initial submission on the Input Methodologies on Emerging Technologies (18 August 2016), especially regarding the importance of the competitive tendering processes for enabling greater transparency and achieving efficient arm's-length equivalent transaction values. We note the Commission has acknowledged some of those points in the paper.

3. Executive Summary

- 3.1 Overall, ERANZ agrees with the issues as identified by the Commission. We agree with the policy intent of the Commerce Commission as expressed in "Input Methodologies review draft decisions: Topic 7: Related party transactions" (June 2016 Topic Paper), that is, "*to ensure that related party transactions cannot be manipulated by regulated suppliers in a way that allows them to extract excessive profits*". We also agree with the summation that the practical application is not currently aligned with the policy intent. We support the Commission taking a more focused assessment of the issues surrounding the operation of related party transactions and are encouraged that the Commission appears to recognise deficiencies in the current arrangements that need to be improved.

- 3.2 ERANZ believes that the issues presented by related party transactions are material and need to be addressed, and that the fitness for purpose of the current information disclosure regime is being challenged and therefore requires amendment. We do not consider that the current information disclosure determinations adequately demonstrate how the value of the related party transactions is linked to, or based on, objectively verifiable information that is quantitative as well as qualitative.
- 3.3 Related party transactions are of importance for ERANZ members because anything that has an impact on the costs to consumers will have an impact on the retail component of the market. Industry participants must be incentivised to keep the costs across the sector as efficient as possible.
- 3.4 ERANZ share the Commission's concerns that suppliers of the regulated service can use an unregulated related party to increase their combined profits by overcharging for inputs to the regulated service that are supplied by the related party, or cross-subsidise the inputs to distort the competitive market. We are particularly concerned that the regulated businesses may be incentivised to use a related party for an input to the related service even though it may not be the most efficient provider of the input. This could result in a detrimental impact on quality and cost to the consumer. At present, there is little transparency to be able to determine otherwise on both counts.
- 3.5 We also know that increasingly the services provided by some related parties within some EDBs are network support services that can be, and are being, provided by the competitive market. For example, demand response or generation such as solar PV, storage batteries, or other distributed generation. This cross-over raises several concerns with the current regulatory framework and the potential for distortion of contestable markets. How related parties are defined, and those rules interpreted and applied, by both the businesses and the auditors, is therefore very important to us.

4. More transparency around procurement procedures is required

- 4.1 ERANZ's position is that the regulatory regime must ensure there is transparency, robust monitoring and rigour in the processes that EDBs employ in the procurement of goods and services from their subsidiaries and associated entities.
- 4.2 ERANZ's considers this to be a two-fold issue:
1. The information disclosures required under the Electricity Distribution Information Disclosure Determination 2012 (ID determination) do not provide sufficient information for a third party or interested persons to assess whether the provisions of Part 4 are being met. ERANZ submits that more extensive information about planning and implementation of EDB network upgrade projects is required to allow interested parties to ascertain the existence and extent of upcoming related party activity. For this reason, we submit that the ID determination needs to be amended.

2. Tendering and procurement procedures are inconsistent. They do not provide the transparency that would allow an interested third party to determine whether the value of a related party transaction is based on a demonstrated objective and independent measure, or if the value and terms of a related party transaction is expressed in a way that is akin to an arm's-length transaction. Without the ability to assess related party transactions in this way, there cannot be confidence the policy intent of the Commission is being met.

- 4.3 Figure 3.4 of the paper (page 33) shows the level of related party transactions across EDBs. The graph appears to indicate a wide difference in the use of related party transactions across EDBs. There may be many reasons for this, such as imperfect markets. However, this may not be the case; the graph could equally indicate a wide variance in EDBs interpretation and application of the current related party rules. Without greater transparency, it is difficult for interested parties to ascertain which is the case.

- 4.4 ERANZ submits that greater transparency would provide assurances that EDBs were not unduly favouring their own related parties at the expense of the contestable market, or not transacting in ways equivalent to arm's length transaction, both of which can have consequences for the consumers. This extends to a wider issue of EDBs potentially predetermining a solution to a network need because of the related parties they already have, versus going out to the market to determine what alternative solutions there could be. For example, a tender for solutions to manage a network constraint could go out to the market, and there may be various options to meet it – regardless of the technology. Batteries may be one option, but demand management and distributed generation are others. The lack of transparency as to how EDBs choose their solutions, (e.g. batteries that are supplied by related entities), over another solution (e.g. distributed generation or demand response provided by non-related entities) is part of the problem with ascertaining whether a related party was unduly favoured, and whether the price and quality was akin to a competitive option.

- 4.5 We contend that providing greater transparency should not be onerous for EDBs. Documentation of procurement practises and related entity transactions should already be being compiled as a routine part of an EDBs internal processes to demonstrate their compliance with the provisions and intent of the Act. A case study to illustrate the need for greater transparency is **attached** in Appendix One.

- 4.6 ERANZ believes that, where EDBs are procuring goods or services from contestable markets, their tendering processes should be open and fully competitive. This is especially important where an EDB's related entity operates to provide services or technologies that are within a competitive market. If an EDB believes that the market for the goods or services they require is imperfect, and therefore an orthodox tendering process is problematic, then the onus should be on the EDB to demonstrate the existence of the imperfect market for that particular good or service. ERANZ submits that the Commission should consider extending the rules to include disclosure of the tendering processes undertaken by an EDB where that EDBs related entity was awarded that tender.

5. Related party transactions are material

5.1 ERANZ is of the view that, based on the data provided by the Commission, related party transactions are material and will increasingly become more so. As the Commission noted, the total volume and value of related party transactions are proportionately large for regulated services and appear to be growing. In 2012 EDBs spent around \$200 million with associated entities. In the year ended March 2016, it was more than \$360 million. This represents an 80% increase over that period and the figure is expected to keep rising. It is right for the Commission to be considering this issue in detail.

5.2 Concern over the levels of EDB investment in related entities was raised in recent speech¹ by the Energy Minister, Judith Collins:

“My starting point is that your core business is electricity lines. You are there to ensure your communities receive efficient and reliable access to electricity infrastructure. We’ve had some notable examples where distribution companies have invested in areas completely unrelated to the sector. I am not privy to the economics of these specific investments and even if I was, that is not necessarily my concern as Energy Minister. My point is that you should aim to stay focused on your core business in order to successfully adapt to technological change, meet the needs of consumers, and ensure that the value of your considerable assets is maintained”.

5.3 There is already a wide variation between EDBs, not only in the range of activities their associated entities undertake, but also in how those related parties are structured to provide services to the EDBs, and the processes they use for purchasing or contracting for those services. The opportunities presented by emerging technologies will further widen the range of contestable services a related party can provide. There is therefore a need to ensure information disclosure, procurement and tendering are carried out in a consistent (both internally within EDBs, and across EDBs), transparent and robust manner to allow for proper analysis to ensure that the consumer of the regulated electricity lines services is not paying more than they should for the relevant services. We submit that the Commission should also consider extending the rules to include disclosure of successful procurement from a related party to the regulated service. This would provide useful information for the competitive market to compete transparently against related parties when tendering for contracts for services, or for the EDB to justify why it favoured its own related party.

5.4 ERANZ submits that the Commission should extend the problem definition to cover EDBs using resources, funded by their regulated business, to enhance the commercial viability of their unregulated commercial revenues. Related party transactions do not only flow one way. Access to these resources at no cost or below cost would give an EDBs related entity an

¹ [Address to Energy Trusts of New Zealand Autumn Conference, 11 May 2011](#)

advantage over their competitors, and the consumer of the regulated service may be cross-subsiding other business ventures that are not being run akin to an arm's-length business.

6. Emerging technology for network support services is only going to exacerbate the issues around third-party transactions

- 6.1 Further to the issues identified by the Commission in its paper, ERANZ remains concerned about the potential exacerbation of related party transaction issues due to the lack of transparency in the allocation of revenue between regulated and unregulated activity, particularly in the case of EDBs utilising network support services from technology that could be provided by the competitive market (i.e. not a natural monopoly service).
- 6.2 The emergence of services that provide benefit to the customer from a customer's premises reflects a turning point in the electricity supply sector. As well as customer benefit, services such as small-scale embedded generation, battery storage, and demand management tools can also provide support back to the grid. These are commonly referred to as behind the meter, or BTM, services. Of equal importance is that this emerging class of energy services is not limited to BTM installation, and that storage, generation or demand management assets in front of the meter may also create benefit and value not related to the conveyance of electricity by a distribution or transmission network.
- 6.3 There are multiple streams of benefit from distributed energy resources technologies and the services they provide cross over multiple markets. These markets must be able to adjust and respond accordingly to meet peak demand – whether generation, transmission, distribution, retail or other. Competition is the best method to efficiently allocate resources. To enable this competition, it is critical that decisions to invest in these services by EDBs become more open and transparent, and are preceded to the extent possible by contestable processes, so that there is greater confidence through information disclosure and procurement processes that outcomes are consistent with outcomes produced in competitive markets.
- 6.4 There is a risk that the development of a competitive market for the provision of network support services - including those provided via emerging technologies and other distributed energy resources - may be stymied through the advantages EDBs and their related party entities can employ over their competitors in the contestable supply of those services. It should also be particularly concerning for the Commission if these related party transactions lock the consumer into a certain option for a set period and they are not offered other choices. For example, the supply of solar or battery storage solutions to a consumer which we understand would have a life-span (based on charge/discharge frequency) of between ten and fifteen years for a typical household.
- 6.5 We are of the view this creates an uneven playing field raising the prospect of related parties being able to establish a more dominant market position than they otherwise would have been able to achieve if this was a fully contestable market and EDBs were required to at least test the market (e.g. on price) in an open and transparent procurement process. If this uneven playing field continues to develop unchecked, we are of the view consumers will pay higher prices for their regulated services as the EDBs will have forgone the dynamic benefits of

effective competition for contestable goods and services. This is then exacerbated due to the lack of transparent and quantitative data on hand at present to evaluate related party transactions and establish whether a customer is paying more than they otherwise would.

- 6.6 We also note that the Commission has identified that there are implementation and compliance issues with the current IMs and ID regimes. We think these issues will increase as services are increasingly provided by distributed energy technologies such as solar and battery storage. We, therefore, encourage harmonisation across those regimes, with emphasis that more should be done on an arm's-length basis, or the equivalent. The basic premise should be that the competitive market is the best mechanism to ensure that excessive profits are not extracted and the regulated service is provided at an efficient cost for the long-term benefit of consumers of the regulated service, and where the competitive market could or can deliver these assets and services then it should.
- 6.7 The issue around the lack of transparency and whether EDBs are potentially favouring their related parties has also been recognised by the Electricity Authority. Their concerns were outlined in their 15 March 2017 letter to ERANZ (**attached** Appendix Two). The relevant passage below:

“Transparency and confidence regarding distributor involvement in the contestable parts of the electricity sector

Some distributors have been involved in competitive activities on their own network for quite some time, which is allowed by the Electricity Industry Act. Part 3 of the Act sets thresholds for distributors being involved in generation and retailing activities.

However, evolving technology is giving rise to new opportunities for distributors to compete on their network-for example, in the form of peer-to-peer retailing-or to 'eat their network' by investing in non-traditional assets such as batteries and associated demand management capabilities. Batteries and demand management capabilities are inherently contestable activities that could be provided by competitors as a service to distributors.

As distributors are in the privileged position of providing monopoly network services we have informed distributors that they need to take great care to avoid using their monopoly position to favour any of their own businesses that compete, or may compete, against other businesses.

We have also informed distributors that if they are involved in competing businesses then it would be desirable they develop - with their customers and competitors - a neutral access policy and information disclosure processes that provides those parties with confidence they are not discriminating in favour of their own businesses. In our view, these needs to go further than simply ensuring equal access to, and sharing of, network data. Competitors will need some way of objectively verifying that the distributor's own business has not received any favourable treatment regarding connecting to and using the network. Similarly, competitors will need some

way of objectively verifying that the distributor has selected the least cost supplier of alternatives to traditional network assets.”

- 6.8 The International Energy Agency (IEA) has also noted the issue of EDB investment in competitive markets in their recent report²:

There are emerging concerns with regulated distribution businesses being able to compete in unregulated parts of the sector. The most obvious are battery technologies, which enable a distributor to defer/avoid line investment but can also be used to sell electricity into the wholesale and ancillary services market. There is potential here to create an “unlevel” playing field and undermine competition, which in the case of New Zealand could have serious ramifications. Rapid technology change and uptake problems in this regard could be exploited rapidly and it may be hard to “turn back the clock”.

- 6.10 ERANZ appreciates that these issues cross over to the competitive parts of the Commission’s mandate, and that of the Electricity Authority, but we submit they are inextricably linked. We encourage a joined-up approach on these matters by the regulatory bodies involved, given the mutual interest and importance of the issues.

7. Potential Solutions

- 7.1 ERANZ welcomes the recognition from the Commission about some of the inadequacies of the current arrangements and their initial views on potential solutions. Our thoughts on these are contained in the table **attached** (Appendix Three). Specifically, we suggest the Commission consider:

- In addition to improving information disclosures, that an effective self-reporting regime is introduced whereby the onus is placed on EDBs to provide evidence of compliance. This could be in the form of EDBs engaging an independent provider to undertake an audit at prescribed intervals of their procurement processes with related parties. With twenty-eight EDBs, and the level and complexity of related party activity, the effort required from the Commission, or other third parties, to actively monitor associated party activity would be significant. We support calls for a process-led audit regime to be put in place that delivers transparent, verifiable outcomes.
- Changes should be made to the current information disclosure regime – the Electricity Distribution Information Disclosure Determination 2012 (ID determination). ERANZ submits that more extensive information about planning and implementation of EDB network development projects is required for third parties to ascertain whether they could compete to participate in those projects or offer alternatives that might defer or reduce the costs of those projects, for the long-term benefit of the regulated consumer.

² [Energy Policies of IEA Countries - New Zealand 2017 Review \(at page 142\)](#)

- Development of a network opportunities map, as a tool to inform third parties (including consumers) about proposed network investments and assist in identifying opportunities for demand management, distributed energy resources, and other non-network solutions, to defer investment. A network opportunities “heat map” has been developed in Australia.³ This is a very useful tool allowing anyone to access the data about network investment considerations and how third parties might be able to offer services to the lines companies. We note a New Zealand example of such a tool was that produced by Powerco, as part of its suite of CPP consultation documents, to assist their stakeholders to understand the network issues they were looking to mitigate via their proposed investments (Appendix Four). We note that EDBs currently do provide details of their network issues within their Asset Management Plans. However, these documents are highly technical and difficult for interested parties to readily comprehend. EDBs providing more accessible user-friendly materials, such as those provided by Powerco and Australian electricity networks, would greatly aid interested parties to understand the distribution network issues prevalent in each region, and would also provide non-related entities visibility of future opportunities.

8. Thank you for the consideration of this submission. We are happy to discuss any parts of this submission in more detail if required. If you have any queries, please contact Jenny Cameron at jenny.cameron@eranz.org.nz

Yours sincerely



Jenny Cameron
Chief Executive

Appendices:

1. Case study
2. Letter from Electricity Authority to ERANZ
3. Potential solutions table
4. Powerco example of regional network issues graphic

³Ausgrid, 15 electricity networks in Australia, and the Institute of Sustainable Futures at University of Technology Sydney, have developed an online tool: <http://www.ausgrid.com.au/Common/Industry/Demand-management/Network-opportunity-maps.aspx>

Appendix One: Case Study

The purpose of this case study is to provide real-world examples of related party transaction issues raised in the ERANZ submission. The examples draw attention to the issue of lack of transparency as to how regulated businesses are making the decisions about which parties they are selecting to provide unregulated services to the network and then how those costs are allocated between the regulated and unregulated parts of the business.

The below examples are drawn from publicly available examples (either media or EDB websites) and cross-referenced against the current the information disclosure available (asset management plans and other information).

Example 1: provision of home energy systems by a regulated network owner

Recent articles⁴ in the New Zealand Herald report on Vector's procurement of 300 home battery systems from Tesla, and of these, the provision of 130 free solar and battery systems to selected consumers on their network.

What is unclear is how the decision was made to procure those battery systems and whether there was any opportunity for any other home battery storage supplier to tender for that service – both to Vector and those customers. It is unclear from the asset management plan where the network need was identified, and what the tendering and procurement process was for the transaction. As an interested party, there is a lack of assurance that Vector did not defer straight to its own related party (which may in this case have been an internal business division).

This is important to clarify for the consumer, because it is unclear how the decision was made on both a price and quality aspect, and therefore whether the regulated consumer is bearing the cost, or subsidising, a less than equivalent to an arm's-length or contestable transaction.

This example also demonstrates an EDB's ability to use its monopoly position to unfairly advantage its related entities, in this case over competing providers of home energy systems. The level of competitive disruption is heightened when it is behind the meter services. If related party advantage creates a non-level playing field in this space, it will stifle the development of a competitive market for provision of these technologies, resulting in less consumer choice and higher cost through lack of competitive pressure that would otherwise exist.

Other examples of recently acquired related parties by Vector which also raise questions around how the regulated and unregulated businesses will be managed and costs allocated, are the purchase of, E-Co Products Group (a supplier of HRV systems) and PowerSmart (a supplier of commercial and domestic solar photo-voltaic systems).

A recent press release⁵ from Vector highlights the confusion as to how the related parties will be treated within the business, and the importance of ensuring that the related party

⁴ http://www.nzherald.co.nz/vector/news/headlines.cfm?c_id=1503810

⁵ <https://www.vector.co.nz/innovation-news/vector-expands-its-energy-solutions-business>

transaction rules are robust, and demonstrably akin to an arm's length transaction:

'E-Co Products Group Chief Executive, Bruce Gordon says E-Co Products is very excited to be joining the Vector group. "As New Zealand's leading energy solutions provider, Vector can provide key expertise and innovation in areas that will benefit our business and take it into a new era," he said'.

'PowerSmart Chief Executive, Mike Bassett-Smith, says Vector's scale and network expertise will assist with the company's growth plans: "As the economics of solar and batteries continue to improve, we can leverage Vector's knowledge and experience to undertake ever larger, more complex projects," he said'.

A 2016 report by ITP Renewables Australia⁶ on the potential for photo-voltaic and batteries in New Zealand makes specific mention of the advantages that New Zealand EDBs enjoy over their Australian counterparts:

'Interestingly, in Australia, something of a battle has developed between electricity retailers and network companies – as both want to be able to participate in the 'behind the meter' distributed energy market. All the major retailers, and many of the smaller ones, are now offering some form of package that not only involves the installation of solar and batteries, but includes a web-based smart energy platform. The network operators also want to move into this market, but unlike their New Zealand counterparts, are generally unable to do so because of the regulated returns they receive via their monopoly status'

Example 2: Regulated network owner procurement of grid scale batteries

Vector have recently installed a grid scale battery system⁷ and is planning to install an additional twelve in different locations in the near term⁸. The system selected by Vector was a 1 MW Tesla Powerpack (cost approx. \$5M). We understand that Vector has partnered with Tesla to bring Tesla's Powerwall system to New Zealand.

We have not been able to locate any information to on the tendering process by which the provider of these battery systems was selected. We have not been able to ascertain whether any consideration was given to alternative providers and, therefore, whether the transaction was equivalent to that of an arm's-length transaction in terms of cost and quality. This example further highlights the need for greater transparency around EDB purchase of equipment sourced from (generation) markets that are competitive.

This highlights a wider issue of EDBs potentially predetermining a solution to a network need because of the related parties (or relationships) they already have, rather than tendering to test whether there are market solutions available. In the example above, where an EDB had identified a network constraint and opted for a generation solution (via a grid-scale battery) there may (or may

⁶http://d3n8a8pro7vhmx.cloudfront.net/seanz/mailings/87/attachments/original/Solar_PV_and_Batteries_Report.pdf?1479682506

⁷ <http://www.energynews.co.nz/news-story/30296/vector-deploys-first-grid-scale-battery>

⁸ http://www.nzherald.co.nz/vector/news/article.cfm?c_id=1503810&objectid=11736123

not) have been other options to meet that need – regardless of the technology – that could have delivered a similar long-term benefit for the consumer of the regulated service. Batteries may be one option, but demand management or distributed generation are others. The lack of transparency as to how EDBs choose their solutions, (e.g. batteries that are supplied by related entities), over another solution (e.g. batteries, or distributed generation or demand response provided by non-related entities) is part of the problem with ascertaining whether a related party was unduly favoured, and whether the price and quality was akin to a competitive option. The point being that both the process for choosing the solution and then the procurement decision for that chosen solution need to become more transparent and justifiable.

Appendix Two: Letter to ERANZ from Electricity Authority



15 March 2017

By Email

Jenny Cameron
Chief Executive
ERANZ

Dear Jenny

The electricity industry is facing exciting opportunities to transform the way it supplies electricity to consumers, and new opportunities to engage with consumers that wish to supply themselves or other consumers. These developments are raising new regulatory issues for the sector, and it is one factor that led the International Energy Agency (IEA) to recommend the New Zealand Productivity Commission review the electricity distribution sector.

The Authority has a project on its active work programme that is similar to that recommended by the IEA, and so we will work carefully to avoid duplication. For example, we may delay aspects of our review (or our entire review) until we have clarity about whether the Productivity Commission will indeed undertake such a review.

Nevertheless, there are broader regulatory issues arising from technology developments that we believe distributors and network users need to address if they are to have a commercially sustainable role in consumers benefiting from new technology and business models.

The purpose of this letter is to discuss matters that have come into sharper focus over the last year. Distributors, with the considerable involvement of retailers, are taking the lead in reforming distribution pricing structures to facilitate better outcomes for consumers, and we are pleased with the proactivity many of you are taking on this matter.

Transparency and confidence regarding distributor involvement in the contestable parts of the electricity sector

Some distributors have been involved in competitive activities on their own network for quite some time, which is allowed by the Electricity Industry Act. Part 3 of the Act sets thresholds for distributors being involved in generation and retailing activities.

However, evolving technology is giving rise to new opportunities for distributors to compete on their network—for example, in the form of peer-to-peer retailing—or to 'eat their network' by investing in non-traditional assets such as batteries and associated demand management capabilities. Batteries and demand management capabilities are inherently contestable activities that could be provided by competitors as a service to distributors.

As distributors are in the privileged position of providing monopoly network services we have informed distributors that they need to take great care to avoid using their monopoly position to favour any of their own businesses that compete, or may compete, against other businesses.

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We have also informed distributors that if they are involved in competing businesses then it would be desirable they develop—with their customers and competitors—a neutral access policy and information disclosure processes that provides those parties with confidence they are not discriminating in favour of their own businesses. In our view this needs to go further than simply ensuring equal access to, and sharing of, network data. Competitors will need some way of objectively verifying that the distributor's own business has not received any favourable treatment in regard to connecting to and using the network. Similarly, competitors will need some way of objectively verifying that the distributor has selected the least cost supplier of alternatives to traditional network assets.

Distribution pricing reforms to reduce barriers to evolving technology

We are pleased with the proactivity of the Electricity Retailers Association of New Zealand (ERANZ), the Electricity Networks Association (ENA) and many retailers and distributors in formulating alternative approaches for distribution pricing. We have reiterated to distributors that it is important they engage fully with electricity retailers operating on their networks to adopt a coordinated approach to communicating with electricity consumers. We have also reiterated that we remain keen on distributors and the ENA continuing their work to adopt common terminology and approaches to moving towards pricing reform.

As you know, the Authority has requested all electricity distributors publish, by 1 April 2017, a roadmap of their process for developing and implementing pricing reforms. As I stated in my letter to distributors on 18 October 2016, the Authority is not requiring distributors to quickly introduce new pricing arrangements as it is important to minimise 'bill shock' that risks undermining the sustainability of new pricing arrangements. In this regard we are particularly supportive of distributors introducing new tariff structures for new connections or specific customer categories, as Unison and Waipa have done, and we are supportive of distributors introducing new tariffs on a trial basis before rolling out new price structures more broadly.

It is important to be clear that the Authority's call in November 2015 for reform of distributor prices was to address poor investment incentives arising from the heavy reliance of most distributors on consumption-based charges. The purpose of our 2015 consultation paper was to highlight that investment distortions could grow quickly as a result of the increasing availability of technologies such as electric vehicles, batteries and solar generation, and to emphasise that distributors need to reform their pricing regimes earlier rather than later to 'get ahead of the curve'.

One matter that has come to our attention is that some distributors have the misconception they should set peak demand or time-of-use (TOU) rates at levels needed to alter consumer behaviour. This is erroneous thinking. In principle, the best outcome for consumers is promoted when the variable component(s) of a tariff reflect the marginal cost of the service being provided. We considered this issue in detail in our 2014 working paper *Transmission Pricing Methodology Review: LPMC charges*. If consumers do not alter their behaviour at efficient price levels then they are signalling they prefer the lines company alters its services rather than altering their own consumption.

The current distribution pricing principles give some guidance on efficient pricing. We are currently reviewing those principles and will engage on these matters this year and into 2017/18.

Concluding comments

New Zealand consumers are facing an exciting future where new technologies offer consumers far greater choices and are likely to further enhance competitive pressure in the electricity sector.

Accordingly, the Authority is undertaking several initiatives to reduce barriers to the entry and expansion of evolving technology and new business models, and we will be consulting on these matters in the rest of this year and into 2017/18. We are also establishing an Innovation and Participation Advisory Group (IPAG) to advise us on many of these issues. We will shortly be announcing the chair of IPAG and issue a call for ordinary members of the group.

It is imperative that competition continues to intensify throughout the country and that emerging competitive markets—such as for the supply of alternatives to network-build solutions—are allowed to develop competitively. We believe you have a key role to play in this effort, and the Authority intends to maintain a watchful eye on developments.

Yours sincerely



Carl Hansen
Chief Executive

Appendix Three: Potential Solutions Table

<i>Table 5.1 Potential solutions for problems with the current related party transactions regime</i>		
<i>Table 5.1 Potential solutions for problems with the current related party transactions regime</i>		
Focus Area	Potential Solution	ERANZ Comment
<p><i>Consideration of imperfect local markets in contracting service.</i></p>	<ul style="list-style-type: none"> • <i>Consideration of further disclosure requirements to provide increased transparency about procurement policies</i> 	<p>ERANZ believes there needs to be greater structure and transparency around tendering and procurement decisions, buttressed by information disclosure and a robust audit regime. Where it is the case that EDBs have engaged their own entities without a competitive procurement process due to pragmatic reasons (such as the lack of alternative providers) we believe an effective regime would put the onus on the EDB to prove their rationale and the efforts they have undertaken in order to be sure of their position. The rationale should also, as much as possible be quantitative as well as qualitative.</p>
<p><i>Complexity of terminology and the understanding of such terminology</i></p>	<ul style="list-style-type: none"> • Clarification of terms through re-defining and/or education; • Reassess: <ul style="list-style-type: none"> ○ <i>directly attributable costs; and</i> ○ <i>17.2% margin applicable to electrical contracting services</i> • <i>The harmonisation of the related party provisions across the IMs and ID. As outlined in our 2016 topic paper and articulated in various submissions, we would like to see a clear alignment of the related party transactions across ID and the IMs. Our intention with a closer alignment of the provisions across ID and the IMs would be to ensure each preferred option would</i> 	<p>ERANZ agrees that related party regulation should be outcome based rather than a prescriptive disclosure check list which can be quixotic and descend over time into an expensive and meaningless box-ticking exercise. This may result in high ongoing compliance costs for EDBs (which are ultimately passed on to end consumers) and yet not provide third parties with visibility or the desired comfort around the veracity of an</p>

	<p><i>derive a valuation which was not materially dissimilar.</i></p> <ul style="list-style-type: none">• <i>Better connection of the purpose across ID and the IMs so that regulated suppliers have a clear understanding of the intention behind each method of disclosure. A clearer understanding of the need and objective of our regulatory disclosure and methodology rules would allow regulated suppliers and industry auditors to understand drivers and objectives of preferred outcomes.</i>	<p>EDBs associated party transactions. The opportunities presented by emerging technologies mean that taking an outcome based approach rather than prescriptive compliance obligations could be more adaptable and fit for future purpose.</p> <p>By outcome based we mean that guiding principles around related party transactions and the rationale for them are clearly defined, with the onus put on EDBs to adequately demonstrate they are compliant through an audit process. This could be in the form of the EDB engaging an independent auditor to provide a report documenting the EDBs procurement processes from associated entities, with the Auditor, and the EDB Board certifying that the EDBs related party transactions meet the guiding principles.</p> <p>These reports would be reviewed by the Commission and be made available to interested parties.</p> <p>Where procurement processes are not practical, due to imperfect local markets as above, then the rationale for these needs to be documented and evidence provided. A model report could provide EDBs guidance on expected format and level of detail.</p>
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ERANZ SUBMISSION: RELATED PARTY TRANSACTIONS - PROBLEM DEFINITION

<p><i>Transparency of our methodology and the valuation of transactions</i></p>	<ul style="list-style-type: none"> • <i>Removal of director certification or inclusion of additional disclosure requirements when disclosing using this less preferred option;</i> • <i>This review may be an opportunity for us to order the disclosure methodologies in preference order. We prefer methodologies which demonstrate contestable processes using a tendering or benchmarking process, which increases the likelihood that the transactions will be akin to arm's-length; and</i> • <i>Information disclosure shows that although there are several disclosure options available, there are a limited number of options being used by the majority. We believe this review may be an opportunity to streamline options, removing those disclosure options which are not commonly used or appear to impose unnecessary compliance costs.</i> 	<p>As above</p>
<p><i>Compliance and disclosure requirements</i></p>	<ul style="list-style-type: none"> • <i>The related party provisions should have the ability to stay current to be able to account for new developments in the sector (e.g., emerging technology).</i> • <i>Alignment of the methodology and policy intent across the IMs and ID to ensure they both achieve consistent outcomes. We wish to have consideration for those applying the related party transaction rules on a day to day basis in completing this review and in the provision of education material following any amendments.</i> • <i>We are considering more targeted disclosure requirements on the contestability and transparency of procurement processes in achieving the purpose of information disclosure.</i> • <i>The quality of such procurement processes should be cited and tested by the auditor in providing assurance of the reasonableness of the transaction. Clear and transparent transactional relationships between the related party and the EDB should be visible in this disclosure.</i> 	<p>As above</p>

Table 5.1 Potential solutions for problems with the current related party transactions regime
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Focus Area	Potential Solution	ERANZ Comment
<p>Consideration of imperfect local markets in contracting service.</p>	<ul style="list-style-type: none"> • Consideration of further disclosure requirements to provide increased transparency about procurement policies 	<p>ERANZ believes there needs to be greater structure and transparency around tendering and procurement decisions, buttressed by information disclosure and a robust audit regime. Where it is the case that EDBs have engaged their own entities without a competitive procurement process due to pragmatic reasons (such as the lack of alternative providers) we believe an effective regime would put the onus on the EDB to prove their rationale and the efforts they have undertaken in order to be sure of their position. The rationale should also, as much as possible be quantitative as well as qualitative.</p>
<p>Complexity of terminology and the understanding of such terminology</p>	<ul style="list-style-type: none"> • Clarification of terms through re-defining and/or education; • Reassess: <ul style="list-style-type: none"> ○ directly attributable costs; and ○ 17.2% margin applicable to electrical contracting services • The harmonisation of the related party provisions across the IMs and ID. As outlined in our 2016 topic paper and articulated in various submissions, we would like to see a clear alignment of the related party transactions across ID and the IMs. Our intention with a closer alignment of the provisions across ID and the IMs would be to ensure each preferred option would derive a valuation which was not materially dissimilar. • Better connection of the purpose across ID and the IMs so that regulated suppliers have a clear understanding 	<p>ERANZ agrees that related party regulation should be outcome based rather than a prescriptive disclosure check list which can be quixotic and descend over time into an expensive and meaningless box-ticking exercise. This may result in high ongoing compliance costs for EDBs (which are ultimately passed on to end consumers) and yet not provide third parties with visibility or the desired comfort around the veracity of an EDBs associated party transactions. The opportunities presented by emerging technologies mean that taking an outcome</p>

	<p><i>of the intention behind each method of disclosure. A clearer understanding of the need and objective of our regulatory disclosure and methodology rules would allow regulated suppliers and industry auditors to understand drivers and objectives of preferred outcomes.</i></p>	<p>based approach rather than prescriptive compliance obligations could be more adaptable and fit for future purpose.</p> <p>By outcome based we mean that guiding principles around related party transactions and the rationale for them are clearly defined, with the onus put on EDBs to adequately demonstrate they are compliant through an audit process. This could be in the form of the EDB engaging an independent auditor to provide a report documenting the EDBs procurement processes from associated entities, with the Auditor, and the EDB Board certifying that the EDBs related party transactions meet the guiding principles.</p> <p>These reports would be reviewed by the Commission and be made available to interested parties.</p> <p>Where procurement processes are not practical, due to imperfect local markets as above, then the rationale for these needs to be documented and evidence provided. A model report could provide EDBs guidance on expected format and level of detail.</p>
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ERANZ SUBMISSION: RELATED PARTY TRANSACTIONS - PROBLEM DEFINITION

<p><i>Transparency of our methodology and the valuation of transactions</i></p>	<ul style="list-style-type: none"> • <i>Removal of director certification or inclusion of additional disclosure requirements when disclosing using this less preferred option;</i> • <i>This review may be an opportunity for us to order the disclosure methodologies in preference order. We prefer methodologies which demonstrate contestable processes using a tendering or benchmarking process, which increases the likelihood that the transactions will be akin to arm's-length; and</i> • <i>Information disclosure shows that although there are several disclosure options available, there are a limited number of options being used by the majority. We believe this review may be an opportunity to streamline options, removing those disclosure options which are not commonly used or appear to impose unnecessary compliance costs.</i> 	<p>As above</p>
<p><i>Compliance and disclosure requirements</i></p>	<ul style="list-style-type: none"> • <i>The related party provisions should have the ability to stay current to be able to account for new developments in the sector (e.g., emerging technology).</i> • <i>Alignment of the methodology and policy intent across the IMs and ID to ensure they both achieve consistent outcomes. We wish to have consideration for those applying the related party transaction rules on a day to day basis in completing this review and in the provision of education material following any amendments.</i> • <i>We are considering more targeted disclosure requirements on the contestability and transparency of procurement processes in achieving the purpose of information disclosure.</i> • <i>The quality of such procurement processes should be cited and tested by the auditor in providing assurance of the reasonableness of the transaction. Clear and transparent transactional relationships between the related party and the EDB should be visible in this disclosure.</i> 	<p>As above</p>

