

Information to IPAG on rules dealing with cost allocation and related parties

- 1.1 Electricity distribution businesses (EDBs), Gas distribution businesses (GDBs) and Gas transmission businesses (GTBs) are subject, inter alia, to the following two mechanisms:
 - 1.1.1 the categorisation and allocation of operating costs and asset values requirements - these are given effect by a combination of IMs and ID; and
 - 1.1.2 the related parties transactions provisions - these are given effect by a combination of IMs and ID requirements.

Cost Allocation

- 1.2 The cost allocation rules apply to EDBs, GDBs and GTBs.
- 1.3 The way costs are allocated between regulated and unregulated services has an important bearing on how efficiency gains from supplying both types of services together are shared with consumers of regulated services over time (ie, s 52A(1)(b) and (c) of the Commerce Act Part 4 purpose), as well as whether investment by regulated suppliers in the provision of other services is not unduly deterred (ie, s 52T(3) of the Part 4 purpose).
- 1.4 Cost allocation in regulatory accounting involves deciding:
 - 1.4.1 which costs are directly attributable to a single service; (ie operating costs and asset values that are wholly and solely incurred in supplying a single service; and
 - 1.4.2 of the costs that are common to more than one service; (ie costs that are not directly attributable) how much should be allocated to each service.
- 1.5 When applied as part of DPP/CPP price-quality regulation, the cost allocation IM provides the rules by which EDBs and GPBs must decide what proportion of shared costs should be recovered from consumers of the regulated services they supply.
- 1.6 When applied under information disclosure regulation, the cost allocation IM provides the rules that suppliers must adhere to when disclosing their cost data (and other financial information that relies on cost data). These rules are important since the allocation of shared costs can have a significant effect on financial results as represented in regulatory accounts provided under an information disclosure regime, which in turn will affect assessments made by interested persons.

- 1.7 Accordingly, the cost allocation methodology standardises the way the allocations of shared costs are reported, which in turn facilitates consistent assessment of performance over time and between regulated suppliers.

Approach

- 1.8 Two approaches to cost allocation are permitted¹:
- 1.8.1 the accounting-based allocation approach (ABAA); or
 - 1.8.2 the optional variation to the accounting-based allocation approach (OVABAA).
- 1.9 Under ABAA operating costs and asset values are allocated based on causal factors, or based on proxy factors where causal-based allocators are not available.
- 1.10 OVABAA is a modified version of ABAA. This approach is open to regulated suppliers to use where appropriate in those situations where the application of the ABAA might unduly deter investments in unregulated services.

Related parties

- 1.11 Related party transactions occur when a regulated supplier transacts with an entity which is related to it by a common shareholding or other common control. Those transactions may not be on arm's-length terms and the input costs of the regulated supplier may not reflect efficient costs that we would expect might otherwise apply in the absence of such a relationship.²
- 1.12 The presence of related party transactions may not promote the purpose of Part 4 of the Commerce Act (Part 4 purpose). The concern is that suppliers of regulated services may have the ability to use a related party to:
- 1.12.1 increase overall profits by overcharging for inputs supplied by the related party; and/or
 - 1.12.2 purchase services from a related party when it is not the most efficient supplier.

¹ The various cost allocation approaches are described in "Information Disclosure for Electricity Distribution Businesses and Gas Pipeline Businesses: categorising and allocating operating costs and asset values. Information Disclosure seminar hand-out March 2013".

² In referring to 'input costs', we are referring to capex and/or opex costs to the regulated supplier.

- 1.13 We are concerned with ensuring that consumers of the regulated service should not be harmed by having to pay higher prices for the regulated service as a result of either of these two causes.
- 1.14 There may be an incentive for the regulated supplier to use an unregulated related party to supply inputs at increased prices (and higher overall profits to the group).
- 1.15 Also, we are concerned that a supplier of a regulated service may be incentivised to use a related party for an input to the regulated service even though it may not be the most efficient provider of the input.
- 1.16 Although our related party provisions cover sales from the regulated supplier to the related party, we consider these transactions are much less common and are less material than the opex and capex inputs from the related party to the regulated supplier.
- 1.17 We are not looking to prevent regulated suppliers from using related parties to provide services, as they can be efficient, giving economies of scale and scope. But there is an onus on a regulated supplier to show that the cost of the underlying service is consistent with the input price that it would have otherwise paid in a transaction on arm's-length terms.

Approach adopted to related party transactions

Principles-based approach introduced

- 1.18 We introduced a principles-based approach where regulated suppliers (EDBs, GDBs and GDPs) need to show when dealing with a related party that the value of purchases and sales is disclosed so that:
- 1.18.1 each purchase is valued at no more than if it had the terms of an independent arm's-length transaction;
 - 1.18.2 a sale or supply to a related party is valued at no less than if it had the terms of an arm's-length transaction; and
 - 1.18.3 the value of any transaction is based on an objective and independent measure.
- 1.19 Consistent with the principles-based approach and to achieve a closer connection with the accounting and auditing standards which are familiar to regulated suppliers, we adopted the wording for 'arm's-length transaction' from the definition in auditing standard.

Testing of competitive markets and benchmarking of transaction values

- 1.20 To meet the 'objective and independent measure' test, regulated suppliers need to disclose how they test competitive markets to value transactions for IM and ID purposes, and be seen to apply that approach in practice.

Disclosure requirements to support the valuation approach

An updated role for the independent auditors

- 1.21 Our decision to use general principles means there is closer connection to the accounting and auditing standards applied by the auditors who provide their opinion on the valuation and disclosure requirements.
- 1.22 The auditor's annual ID assurance report is required to state whether in the auditor's opinion the valuation and disclosure of related party transactions each year, in all material respects, shows that it complies with the general related party transactions valuation rule.

Our disclosure requirements

- 1.23 There are a number of disclosure requirements if a supplier of the regulated service transacts with a related party in a disclosure year, including:
- 1.23.1 disclosure of related party relationships;
 - 1.23.2 disclosure of the regulated supplier's procurement policies and processes in respect of a related party relationship;
 - 1.23.3 disclosure of policies which require or have the effect of requiring a consumer to purchase unregulated services from a related party that is related to the regulated service;
 - 1.23.4 details of how and when the regulated supplier last tested the market valuation of transactions in at least one expenditure category; and
 - 1.23.5 a map of anticipated network expenditure and network constraints likely to involve expenditure by the regulated supplier with related parties.

Reduced disclosure requirements in some cases so that the cost and effort proportionate

- 1.24 There is a 'de minimis' threshold that limits the need for disclosure requirements where suppliers have lower levels of total expenditure or a minimal proportion of related party transactions. We think this will ensure that compliance costs are proportionate to the size of the supplier and its level of related party transactions.
- 1.25 The 'de minimis' thresholds for limited disclosures apply where a supplier has:
- 1.25.1 total annual expenditure of \$20 million or less; or

- 1.25.2 under 10% of total annual expenditure made up of related party transactions.

More detailed reporting in other cases

- 1.26 The supplier of the regulated service is required to seek a further more detailed report from the independent auditor or another qualified independent expert if:
- 1.26.1 the related party transactions are 65% or more of a year's total operating expenditure (**opex**) or capital expenditure (**capex**) spend; or
 - 1.26.2 the independent auditor is not able to conclude that the valuation or disclosures of related party transactions complies with the related party rules.
- 1.27 That regulated supplier is required to obtain and disclose this independent report in any year if:
- 1.27.1 there was no report published for one of the immediately prior two years; and
 - 1.27.2 the total value of related party transactions in each of the opex or capex categories has increased by more than 5% for any year since the year looked at in the last report.
- 1.28 The link to the decision and determination guidance on related parties follows.
https://comcom.govt.nz/_data/assets/pdf_file/0029/59591/Related-party-transactions-Input-Methodologies-review-Final-decision-and-determinations-guidance-21-December-2017.pdf

Cost allocation and related rules do not extend to Transpower

- 1.29 The main reason that the related party rules and the cost allocation rules were not applied to Transpower was because apart from system operator services (which is regulated by the Electricity Authority), Transpower previously did not own and operate many non-regulated services; especially not non-regulated services that provided alternative network solutions. Because the system operation contract is agreed with the Electricity Authority, under Part 4, operating costs or asset values allocated to activities to supply transmission services other than system operation services, must net out any costs or asset values recoverable by Transpower under the service operation agreement with the Electricity Authority.
- 1.30 The Transpower related party provisions in clause 2.2.7(1)(f) to (h) of the Transpower IMs and clauses 17 to 19 of the Transpower ID requirements are simplified arm's-length valuation requirements (see appendix to this note). When

the EDB, GDB and GTB related party transactions requirements in their IMs and ID were updated at the 2016 IM Review, the decision was made not to update Transpower's requirements, as there was not the same perceived problem as for those other network entities.

Commission open to considering extending the related party and cost allocation rules to Transpower

- 1.31 The Commission is open to considering the extension of key elements of the related party transactions and cost allocation mechanisms to Transpower, and in the first instance it would be able to be considered as part of the upcoming IM review.
- 1.32 The scope of the IM Review requires reviewing all existing rules, and must be completed by December 2023, following consultation with interested parties. However, Part 4 does not permit any IM changes to have any impact on Transpower's individual price-quality path until the next regulatory period, from April 2025.
- 1.33 Any consequential ID changes could also potentially be made alongside the IM Review.

Funding for Transpower's DR programme

- 1.34 Transpower's DR programme is not funded directly under RCP3.
- 1.35 Transpower funds its DR through its opex allocation (which is fungible) under RCP3.

Appendix

Relevant extracts from the Input Methodologies (IM) and Information Disclosure (ID) rules applying to Transpower are shown below highlighted in yellow.

Extract Transpower's IM

2.2.7 Value of commissioned assets

- (1) Value of commissioned asset, in relation to an asset, is the cost of the asset to **Transpower** determined by applying **GAAP** to the asset as on its **commissioning date**, except that the cost of-
- (a) an intangible asset, unless it is-
 - (i) a **finance lease**; or
 - (ii) an **identifiable non-monetary asset**,is nil;
 - (b) an **easement** created by **Transpower** in respect of **easement land**, is limited to the sum of-
 - (i) legal and administrative costs incurred by **Transpower** in relation to the **easement's** creation;
 - (ii) compensation, determined by a **valuer**, for any amount that would otherwise have been paid by **Transpower** on arm's-length terms to a third party owner of **easement land** as compensation for the permanent and material reduction in the value of the **land** or disruption, on account of the **easement's** creation; and
 - (iii) the cost of financing the purchase of the **easement land**, determined in respect of the period on and from the date of acquisition until the **easement's** creation,where any gain or loss made by **Transpower** on the sale or disposal of the **easement land** is ignored;
 - (c) **easement land**, is nil;
 - (d) an asset used in providing **electricity transmission services** pursuant to a **new investment contract**, is nil;
 - (e) a **network spare** whose cost is not treated wholly as or part of the cost of an asset under **GAAP**, is nil;
 - (f) an asset-
 - (i) acquired from another **regulated supplier**; and
 - (ii) used by that **regulated supplier** in the **supply of regulated goods or services**,

is limited to the unallocated closing RAB value of the asset that would have applied for the other **regulated supplier, had the asset not been acquired by Transpower in the disclosure year of the regulated supplier when the asset was transferred** (as 'unallocated closing RAB value' is defined in the **input methodologies** applying to the **supply of regulated goods or services** by the other **regulated supplier**);

- (g) an asset that was previously used by **Transpower** in its **supply of other regulated goods or services** is limited to the unallocated opening RAB value of the asset in relation to those **other regulated goods or services** as on the day before the **commissioning date** (as 'unallocated opening RAB value' is defined in the **input methodologies** applying to the **regulated goods or services supplied by Transpower**); and
- (h) an asset acquired from a **related party** other than an asset to which paragraphs (f) or (g) apply is-
 - (i) its depreciated historic cost in respect of the **related party** determined by applying **GAAP** as on the day before the acquisition by the **Transpower**; or
 - (ii) where sufficient records do not exist to establish this cost, its market value as at its **commissioning date** as determined by a **valuer**.

(2) When applying **GAAP** under subclause (1), the cost of financing-

- (a) is applicable only in respect of the period commencing on the date the asset becomes a **works under construction** and terminating on its **commissioning date**; and
- (b) calculated using a rate not greater than **Transpower's** weighted average of borrowing costs for each applicable **disclosure year**.

(3) For the purposes of subclause (2)(b), the 'weighted average of borrowing costs' is calculated for a **disclosure year** using principles set out in **GAAP**, where:

- (a) the cost of financing rate is the weighted average of the costs applicable to borrowings in respect of **capital expenditure** that are outstanding during the **disclosure year**;
- (b) the total costs applicable to borrowings outstanding, as used in calculating the weighted average, must include costs of borrowings made specifically for the purpose of any particular –
 - (i) **capital expenditure projects**; or
 - (ii) **capital expenditure programmes**; and
- (c) the amount of borrowing costs capitalised during the **disclosure year** must not exceed the amount of borrowing costs incurred during the **disclosure year**.

(4) For the avoidance of doubt-

- (a) revenue derived in relation to **works under construction** that is not included in regulatory income under an **ID determination** or preceding

- regulatory information disclosure requirements reduces the cost of an asset by the amount of the revenue where such reduction is not otherwise made under **GAAP**;
- (b) where expenditure on an asset which forms part of the cost of that asset under **GAAP** is incurred by **Transpower** after the asset was first **commissioned**, such expenditure may be treated, at **Transpower's** election, as relating to-
- (i) that asset; or
 - (ii) a separate asset.

Information Disclosure - Related party transactions

17. For the purpose of sub-clauses 8.21.4 and 8.21.5 the cost of any **commissioned** asset acquired by **Transpower** from a **related party** must be as determined in accordance with sub-clause 2.2.7(1)(g)-(h) of the **Transpower IM**.
18. For the purpose of sub-clauses 8.21.4 and 8.21.5 the cost of any service or goods (other than a transaction relating to a **commissioned** asset) acquired by **Transpower** from a **related party** must be:
- 18.1 the directly attributable cost incurred by the **related party** in accordance with the cost allocation process set out in clause 2.1.1 of the **Transpower IM**, provided that the cost incurred by the **related party** in providing the service to **Transpower**:
 - 18.1.1 is fair and reasonable to **Transpower**; and
 - 18.1.2 is substantially the same as the cost incurred by the **related party** in providing the same type of goods or services to unrelated parties; or
 - 18.2 the **price** paid by **Transpower** where:
 - 18.2.1 the **price** paid for all services and goods acquired from that **related party** is less than one percent of **Transpower's** total revenue from the supply of **electricity lines services** for that year; and
 - 18.2.2 the total **price** paid for all **related party** transactions is less than five percent of **Transpower's** total revenue from the supply of **electricity lines services** for that year; or
 - 18.3 the **price** paid by **Transpower** to the **related party** following a competitive tender process, provided that-
 - 18.3.1 the **price** is no more than five percent higher than the **price** of the lowest qualifying proposal received;

18.3.2 all relevant tender specifications and material to enable unrelated parties to submit a proposal was provided to unrelated parties, or made available upon the request of unrelated parties;

18.3.3 at least one other qualifying proposal was received; and

18.3.4 the final agreement for the provision of the services or goods by the **related party** does not include any **special contract terms**; or

18.4 the **price** paid by **Transpower**, provided no fewer than 2 **Transpower directors** provide a written certification that they are satisfied that the **price(s)** paid for all such services and, goods acquired from **related parties** reflect the **price(s)** that would be paid in an arm's-length transaction; or

18.5 nil.

19. For the purpose of sub-clauses 8.21.4 and 8.21.5 the **price** received by **Transpower** for any sale or supply of services, goods, or assets to a **related party**, must be one of the following:

19.1 if the **related party** is another **regulated supplier** required to **publicly disclose** the **price** paid or cost incurred in accordance with another **Commission** determination, then the **price** received must be that disclosed by the **related party**; or

19.2 the **price** received from the **related party**, provided that no fewer than 2 directors of **Transpower** provide a written certification that they are satisfied that the **price(s)** received for all services, goods, or assets provided to **related parties** reflect the **price(s)** that would be received in an arm's length transaction; or

19.3 at the cost incurred by **Transpower** in providing the service, good, or asset.