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Dear Keston

Related party transactions: Draft decision and determinations guidance

This is the First Gas submission on the Commerce Commission's consultation paper "Related party transactions: Draft decision and determinations guidance" dated 30 August 2017 ("guidance paper").

First Gas supports the move to a principles-based approach to related party transaction (RPT) rules and disclosures. However, we are concerned that the Commission's draft decision is not calibrated to the scale of any identified problems and will create compliance costs that outweigh any corresponding benefits. The analysis of RPTs to date has not adequately considered the range of reasons that a regulated business may opt to use a related party to deliver services, and has not been able to draw conclusions on whether the use of related parties is in consumers' interests.

Since the use of related parties could (conceptually) either benefit or harm consumers' interests, the Commission should seek to substantiate concerns about the use of RPTs through empirical evidence where possible. We present some high-level analysis in this submission that suggests businesses using related parties for operating purposes do not systematically incur higher levels of opex than parties that make no use or limited use of related parties. While we acknowledge that further analysis would help to strengthen or refine this conclusion (and extend it to the use of RPTs for capital expenditure), we urge the Commission to carefully calibrate any changes to RPT disclosures with the relatively modest scale of problems identified.

We also note that concerns about RPTs focus on their use in the electricity sector, with no parties mentioning gas pipelines in this review to date. The specific concerns raised concentrate on the risk that electricity distribution businesses (EDBs) may use RPTs to obtain value from emerging technologies that would be better governed by competitive forces, rather than regulatory rules. As a business focused on gas pipeline services, First Gas does not hold any particular views on that problem. However, we do believe that this focus of concerns means that a lighter touch for gas pipelines in this area is required to calibrate the costs and benefits of regulation.

Given these concerns, we recommend that the Commission only applies the increased information disclosure requirements (as drafted) to gas pipeline businesses (GPBs) prior to a DPP reset or CPP application. We consider this approach strikes the right balance for gas pipelines because it:

- Places the onus on GPBs to demonstrate the value that is being achieved through related parties as part of achieving the expenditure objective considered at price-quality resets;
- Provides transparency to the Commission and stakeholders at a key decision point – when prices/revenues are being set for a regulatory control period; and
- Achieves these regulatory objectives with lower compliance costs than the draft determination proposed by the Commission.

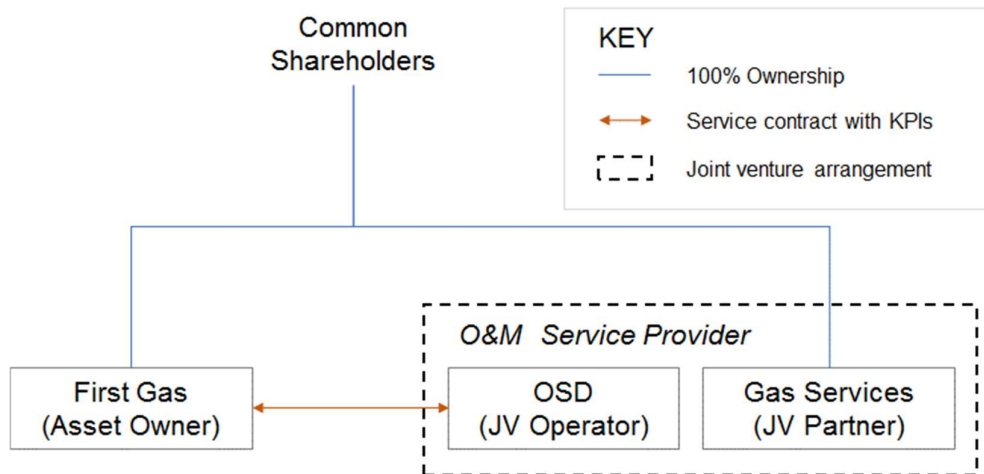
We outline each of these points below, after providing some additional information about how First Gas currently makes use of RPTs.

firstgas.co.nz

Overview of First Gas and our related party transactions

First Gas Limited uses a related party, Gas Services, to deliver operating and maintenance services to our regulated business through a joint venture (JV) with OSD Pty Limited, an independent gas pipeline operations and maintenance company from Australia. The joint venture is responsible for all First Gas operations. An overview of this structure is provided in Figure 1.

Figure 1: Structure of First Gas Related Party Transactions



This structure was adopted to improve the operational performance of the assets acquired to create First Gas. First Gas Limited was established in April 2016, when Colonial First State Investments acquired Vector Gas Limited (Vector’s gas transmission and non-Auckland gas distribution networks). The Maui gas transmission business was acquired by First Gas in June 2016. In formulating its bid for Vector Gas Limited, First State Investments established the joint venture arrangement with OSD described above.

We believe that the JV structure provides benefits to First Gas and our customers, particularly in a post-transaction environment. The JV provides access to the broadest range of experience and capability for our gas pipeline businesses by combining the expertise of staff acquired from Vector Gas Limited with the international expertise of OSD (particularly in adopting best practices from Australia). The JV also helps to align the interests of First Gas as an asset owner with OSD as the operator of the JV, ensuring that any divergence between long-term and short-term incentives is directly and efficiently resolved. First Gas and OSD have a service contract in place that clearly specifies the outcomes that the JV is expected to deliver, with specific Key Performance Indicators (KPIs) that drive levels of service performance expected by our shareholders and customers.

The services provided by our JV are described in our annual information disclosures (IDs).¹ Under the existing regulatory rules, we have applied clause 2.3.7(2)(b) of the Information Disclosure Determination for reporting operating costs incurred by the JV, and we value capital projects managed by the JV as per clause 2.2.11(5)(e) of the Input Methodologies.

Regulation should not distort choices on business structure

The increased use of RPTs by regulated businesses appears to have been the catalyst for the Commission’s review, alongside a concern that this affects the achievement of the Part 4 purpose. The Commission, and submitters, have raised concerns that the use of RPTs may adversely affect consumers in:

- Adversely affecting the ability of regulated businesses to constrain prices;
- Affecting the level and timing of investment and reducing the pressure for the commercial relationship to be innovative; and

¹ Available on our website at: <http://firstgas.co.nz/about-us/regulatory/>

- Not enabling parties to determine whether RPTs are being undertaken at equivalent arms-length terms (due to a lack of transparency).²

The review has focused on how the regulatory regime can ensure that the costs incurred through RPTs are efficient, and the increase in transparency that would help to safeguard this outcome.

In our view, the review of RPTs should recognise the reasons that it is generally in consumers' interest for regulated businesses (and businesses in general) to choose to structure their affairs through insourcing, outsourcing, using related parties, or some combination of these approaches. The best option will depend on the particular circumstances of each business, and the focus of economic regulation should therefore be to encourage suppliers to make the choices that deliver value.

When making decisions on whether to insource, outsource or use related parties for First Gas, we have factored in:

- The capability of the business to deliver the required services at an acceptable quality;
- Access to labour, particularly in remote and isolated regions covered by our networks;
- Access to expertise, including the ability to incorporate best practices from overseas to drive operational efficiencies;
- The cost of providing the services relative to other options;
- The unique nature of the services to be provided; and
- The ability to cross-sell services and expertise to other organisations.

Each of these factors will help determine what is the best structure to provide the services to end-consumers at the right level of cost and quality.

First Gas believes that the role of the regulator in this decision-making process is to ensure that structural choices and service delivery arrangements are based on business need and consumer interests, rather than being driven by regulatory rules. This means that the regulatory rules should not incentivise or dis-incentivise particular business structures.

A problem has been defined, but is not well scoped

First Gas is concerned that the Commission has not established a clearly defined problem with the RPT regime and provided sufficient supporting evidence to justify the level of intervention proposed.

No evidence that related parties are increasing cost (or decreasing quality)

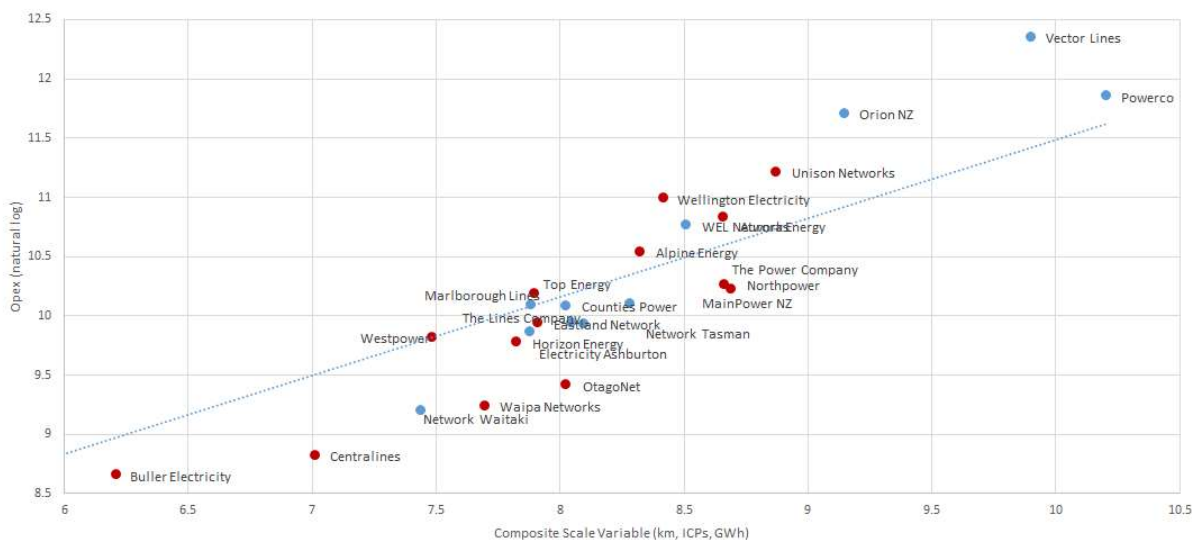
The draft decisions paper and problem definition paper both clearly show that amount of regulated business expenditure through RPTs is increasing, with the absolute dollar value and proportion of opex and capex expended through RPTs both increasing since 2012. From reviewing these statistics, the Commission appears to be concerned that current rules are incentivising the use of RPTs, over the alternatives of insourcing and outsourcing.

However, through the two consultation papers and submissions received to date, no evidence has been presented on the impact that higher levels of RPTs are having on consumers. It is unclear from the evidence presented to date whether RPTs are increasing the costs paid by consumers or the quality of service they receive, and therefore whether or not the use of RPTs is in consumers' long term interests.

The type of analysis we expected to see is presented in Figure 3 below. This evaluates opex by regulated supplier (for EDBs only) and adjusts for scale factors using the Commission's approach to evaluating likely changes in opex over a coming regulatory period at DPP resets. The general trend is as expected – with larger EDBs incurring higher operating costs, although increasing at a decreasing rate (i.e. with some economies of scale). We have highlighted (with red dots) the parties that use related parties to deliver services that account for more than 30% of total opex (based on figure 3.4 of the problem definition paper). The key point is that these parties do not systematically incur higher total opex than parties that make no use or limited use of related parties – with the red dots sitting both below and above the trend line that adjusts opex for scale.

² Section X7 of the draft decision.

Figure 2: Opex determined by scale and related parties



There are a range of statistical techniques that could be used to provide further confidence on this result, and time series data could also be used to ensure that the result does not just reflect conditions in a single year (the Commission has been collecting this data through IDs for several years). The analysis could also be extended to consider whether the use of related parties to deliver capital expenditure also has no identifiable impacts on cost. We have not undertaken this analysis, but suggest that this could help the Commission better establish the magnitude of the problem – and to ensure that any response is calibrated.

Particular concerns appear to relate to emerging technologies in the electricity sector

First Gas considers that the current review of the use of RPTs is being heavily influenced by the current debate in the electricity sector on emerging technologies that could disrupt existing arrangements for supplying electricity.

Of the 16 submissions received on the Problem Definition paper,³ the vast majority of submissions were from electricity distribution businesses (EDBs), energy retailers and their representative bodies (ENA and ERANZ). Many of the retailers’ concerns centred around the move of EDBs into unregulated business lines, particularly in supplying emerging technologies like battery storage. As EDBs enter these markets, retailers are concerned that EDBs could use their regulated businesses to subsidise unregulated activities being undertaken through RPTs (distorting outcomes in unregulated markets). Retailers noted that their concerns had also been raised by the Electricity Authority and the International Energy Agency (IEA). For example, ERANZ states that it knows 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

³ *Related party transactions – Invitation to contribute to problem definition*, 12 April 2017, Commerce Commission, <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/related-party-transactions-provisions/>

⁴ *Related party transactions: Invitation to contribute to problem definition*, 17 May 2017, ERANZ submission to the Commerce Commission.

Retailers subsequently place a high importance on the Commission ensuring that an effective RPT regime applies to EDBs.

In contrast, the EDBs who submitted on the Problem Definition paper all seem concerned that the Commission has overstated the problem with RPTs. These businesses note that the Commission has provided no strong evidence to justify the problem and there seems to be a bias towards assuming EDBs are misapplying the rules. EDBs also expressed concern that the RPT regime also may not be future-proof. For example, Unison notes that:

“As part of Unison’s smart-grid initiative, we have developed a set of software tools that are likely to have commercial value to third parties. These tools have high levels of intellectual property (IP) (intangible value) and lower tangible value. In order to commercialise the tools, it may ultimately prove necessary to place these tools into a related party to provide assurance to third parties purchasing these services that confidential information about their networks is ring-fenced from Unison.....Unison submits that the related party-transaction rules need to be capable of recognising the ways in which services with a high IP content are priced in the market.”⁵

The submitting EDBs state that many of the problems the Commission raised are symptoms of the primary problem – an overly complex regime that has difficulty being interpreted and applied.

We note that none of the submissions expressed any concerns or provided evidence about the use of RPTs by GPBs. The submissions were very much dominated by views of parties in the electricity sector. In our view, this is because the risks around value capture in new markets is much lower for gas pipelines – with services for pipeline capital and maintenance services taking place in a more mature market context.

Issues with the interpretation and application of the RPT regime

The submissions received on the Problem Definition paper all agree that there are issues with the interpretation and application of the RPT rules, and inconsistencies in how RPTs are treated across Information Disclosure (ID) and the Input Methodologies (IMs). With the large number of disclosure options available for both opex and capex, it is also clear that not all of these options are providing the level of transparency sought by consumers or the Commission.

First Gas believes that improvements to RPTs are clearly warranted. We agree that the current IMs are not well crafted in this area. Drafting amendments across both the IMs and the IDs would aid consistent interpretation and subsequent application of the rules by both EDBs and GDBs.

More prescriptive requirements would carry higher risks of unintended consequences

We support the Commission’s intent (described at paragraph 5.25 of the guidance paper) not to specify prescriptive requirements on how regulated suppliers should test the market. In our view, prescriptive requirements carry higher risks of unintended consequences, including:

- **A loss of legitimacy in tendering processes.** If the Commission required all services provided by related parties to be tendered, we believe this would pose a risk to the integrity of tendering processes. Depending on how such a requirement was applied, parties competing with related parties could come to see their role as simply establishing a benchmark price for awarding the contract (sometimes referred to as becoming a “stalking horse”).
- **More insourcing, with less competition and visibility of efficient costs.** More prescription would also likely lead to higher compliance costs in tendering and transitioning from one service provider to another. This would tend to increase the use of insourcing by asset owners, leaving little or no competition in the market (contrary to the regulatory intent of RPT rules and disclosures).

Proposed approach to better reflect the scale of the defined problem

While we support a principles-based (rather than prescriptive) approach to RPT rules and disclosures, the Commission needs to ensure it calibrates the solution to the scale of the demonstrated problem.

⁵ Unison submission on the Problem Definition paper, 17 May 2017.

As outlined above, First Gas considers that there are good reasons to suggest that the problems with the RPT are relatively minor:

- From our analysis, the observed costs of regulated businesses that use related parties are not systematically different to regulated businesses that do not use related parties (when adjusted for scale effects);
- Concerns are focused on EDBs and their use of related parties for emerging technologies. Electricity retailers are concerned that there is no transparency around these transactions to determine whether cost-shifting might distort outcomes in the emerging technology market. No concerns have been raised about the use of RPTs by GPBs; and
- Changing the rules for RPTs carries relatively high risks of unintended consequences.

Given these observations, we believe that the RPT regime reflected in the draft decisions overshoots an optimal solution and introduces unjustified compliance costs. Considerable resource will need to be dedicated to meeting the new ID requirements on an annual basis, and there will be extra costs associated with the additional audit and independent review requirements.

Rather than require regulated businesses to meet yearly disclosure requirements, First Gas recommends that regulated businesses be required to meet the increased disclosure requirements (as drafted) only prior to DPP resets or as part of CPP applications. The lower level of compliance cost involved in making these disclosures prior to resets appears particularly appropriate for GPBs, given that emerging technology risks are predominantly focused in the electricity sector.

We believe this approach meets the needs of the Commission and stakeholders as it:

- Places an additional burden on parties that want to use related parties to demonstrate to their auditors, Boards and ultimately the Commission that those arrangements are providing value for money (and are therefore in the long-term interests of consumers); and
- Provides transparency at key decision points – when a regulated businesses revenue is being scrutinised and determined for the next few year regulatory period (or the period sought through a CPP).

We also note that this approach is similar to that adopted for asset management plans (AMPs), where full AMPs are only required at certain points in a regulatory period and lighter disclosures are available at other times.

Conclusion

If you have any questions regarding this submission, please contact me on 04 04 979 5361 or Karen Collins, Regulatory Manager, on 04 979 5368 or via email at karen.collins@firstgas.co.nz.

Yours sincerely



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