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COMMERCE COMMISSION

Decision No. 575

Determination pursuant to the Electricity Industry Reform Act 1998 (EIR Act), in the matter of an application for exemption, of a cross-involvement in an electricity lines business and electricity supply businesses from the application of the Electricity Industry Reform Act 1998 (EIR Act). The application is made by:

EASTLAND NETWORKS LIMITED

The Commission:

P R Rebstock
D R Bates
D F Curtin

**Summary of the
Application:**

Application by Eastland Networks Limited for exemption from sections 5 and 25 of the Electricity Industry Reform Act 1998 in respect of certain prohibited cross-involvements that would result from a proposed investment in renewable generation

Determination:

The Commission, pursuant to s81 of the EIR Act, declines to grant an exemption.

Date of Determination:

15 March 2006

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BRACKETS**

TABLE OF CONTENTS

EXECUTIVE SUMMARY	I
Introduction	i
The Commission’s Criteria	i
<i>Incentives or Opportunities to Inhibit Competition in the Electricity Industry</i>	<i>i</i>
<i>Incentives or Opportunities to Cross-Subsidise Electricity Generation Activities From Electricity Line Business Involvements</i>	<i>ii</i>
<i>Creation of a Relationship not at Arms Length.....</i>	<i>ii</i>
Determination	ii
INTRODUCTION	1
COMMISSION PROCEDURES	1
General	1
Criteria Used by the Commission to Consider Exemption Applications.....	1
PARTIES.....	2
The Applicant	2
<i>Eastland Network Limited (Eastland).....</i>	<i>2</i>
Other Parties.....	2
<i>Hydro-Electric Corporation (Hydro Tasmania).....</i>	<i>2</i>
<i>Other interested parties.....</i>	<i>2</i>
THE PROPOSAL.....	3
APPLICATION OF THE ACT	3
Electricity Lines Business Involvements	3
Electricity Supply Business Involvements.....	4
Cross-Ownership Prohibition	5
<i>Exemption for Generation from New Renewable Energy Source</i>	<i>5</i>
Corporate Separation and Arms Length Rules.....	6
The Meaning of Cross Involvement.....	7
The Commission’s Exemption Power.....	8
Summary of Application of the EIR Act and Cross-Involvements	8
THE COMMISSION’S EXEMPTION POWER IN RELATION TO S46A	8
EXAMINATION IN TERMS OF THE COMMISSION’S CRITERIA.....	9
Question 1: Incentives or Opportunities to Inhibit Competition in the Electricity Industry	9

<i>Regional Electricity Distribution Markets</i>	10
<i>National Electricity Generation and Wholesaling Market</i>	10
<i>Regional Electricity Retail Market</i>	10
<i>Conclusion on Question 1</i>	11
Question 2: Incentives or Opportunities to Cross-subsidise Generation Activities	12
<i>Conclusion on Question 2</i>	13
Question 3: A Relationship Not at Arms Length	13
<i>Conclusion on Question 3</i>	13
<i>Other considerations</i>	13
Conclusion in Respect of the Commission’s Criteria	14
THE COMMISSION’S DETERMINATION	15
APPENDIX 1	16

EXECUTIVE SUMMARY

Introduction

- 1 On 5 July 2005 the Commerce Commission (the Commission) registered an application (the Application) from Eastland Networks Limited (Eastland) for exemption from sections 5 and 25 of the Electricity Industry Reform Act 1998 (the EIR Act).
- 2 Eastland is proposing to construct a 12MW wind farm at Mokairau, approximately 30km north-east of Gisborne. Eastland has submitted that the project is likely to be a 50/50 joint venture with Hydro Tasmania.
- 3 Eastland is proposing to retail the generation of the wind farm directly to consumers on Eastland's distribution network. To do this, Eastland wishes to enter into hedge arrangements with end users.
- 4 Eastland submitted that a key reason for needing to invest in the generation is to avoid substantial costs involved in upgrading transmission lines between the local network and the national grid which are presently capacity constrained. Further, Eastland has submitted that it has forecast electricity demand to exceed that which can be supplied over the transmission assets, in the near future.

The Commission's Criteria

- 5 In considering an exemption from the EIR Act the Commission has regard to the purposes of the Act and the extent to which granting the exemption would promote or inhibit these purposes.
- 6 To do this, the Commission obtains and evaluates objective answers to the following questions in relation to the particular purpose of Parts 1 to 5 of the EIR Act:
 - Would the Commission, by granting an exemption in respect of a business or involvement or interest, create incentives or opportunities to inhibit competition in the electricity industry?
 - Would the Commission, by granting an exemption in respect of a business or involvement or interest, create incentives or opportunities to cross-subsidise generation activities from electricity lines businesses?
 - Would the Commission permit, by granting an exemption in respect of a business or involvement or interest, a relationship between an electricity lines business and an electricity supply business which is not at arms length?

Incentives or Opportunities to Inhibit Competition in the Electricity Industry

- 7 The Commission is of the view that in respect of the national electricity generation and wholesaling market and in regional¹ electricity distribution markets, granting an exemption, in this case, would not create incentives or opportunities for Eastland to inhibit competition.
- 8 In respect of the Gisborne and Wairoa electricity retailing markets, the Commission considers that an exemption would create incentives and opportunities to inhibit competition, including:

¹ Specifically the Gisborne and Wairoa networks

- the lines business charging electricity retailers for access to lines and contract administration more than it charges itself;
- the lines business cross-subsidising its retailing business from its monopoly lines business;
- the lines business delaying or inhibiting access to its lines by its retail competitors;
- the lines business giving preferential treatment to their own retail customers on the network;
- the lines business may have information regarding the best customers on its network to the disadvantage of its retailing competitors;
- lines connections could be slower for non-retail customers;
- differential treatment in respect of outages; and
- selectively (to the extent possible) preventing customer transfers.

Incentives or Opportunities to Cross-Subsidise Electricity Generation Activities From Electricity Line Business Involvements

- 9 The Commission considers that granting an exemption from the Arms Length Rules in this case would not create incentives or opportunities (that did not already exist) to cross subsidise between lines activities and generation activities.
- 10 The Commission considered whether the incentives or opportunities to mis-allocate cost from the generation business to the lines business might be increased as a result of granting an exemption and considers that such incentives or opportunities would not be increased materially by granting an exemption from selected arms length rules whilst requiring compliance with others.

Creation of a Relationship not at Arms Length

- 11 The Commission is of the view that, in this situation, an exemption would create a relationship that is not at arms length and would also have practical consequences in facilitating the anticompetitive effects identified above, in relation to expanded incentives or opportunities to inhibit competition.

Determination

- 12 The Commission determines to decline the Application by Eastland for exemption from sections 5 and 25 of the EIR Act.

INTRODUCTION

- 1 On 5 July 2005 the Commerce Commission (the Commission) registered an application (the Application) from Eastland Networks Limited (Eastland) for exemption from sections 5 and 25 of the Electricity Industry Reform Act 1998 (the EIR Act).
- 2 Specifically, Eastland seeks exemption from the obligation to comply with the Arms Length Rules and seeks to be permitted to enter into a hedge arrangement for the sale of that electricity direct to end users.

COMMISSION PROCEDURES

General

- 3 For the purpose of considering this application for exemption, the Commission, in terms of s58 of the EIR Act which applies s105 of the Commerce Act 1986 to the EIR Act, has delegated its powers under s81 of the EIR Act to P R Rebstock, Chair; D R Bates QC and D F Curtin, Commissioners.

Criteria Used by the Commission to Consider Exemption Applications

- 4 The EIR Act gives the Commission wide powers of enforcement, extension and exemption. To provide assistance to parties affected by the EIR Act, the Commission set out its role and processes in Practice Note No.3.²
- 5 The Commission stated in Practice Note No.3 that:

The EIR Act provides for the Commission to make exemptions in terms of section 81 of the Act. In considering applications for exemptions, the Commission will have specific regard to the particular purpose of Parts 1 to 5 of the EIR Act as defined in section 2(2) of the EIR Act. The Commission is likely to grant an exemption in respect of a business or involvement or interest only where doing so:

- (a) would not result in certain involvements in electricity lines businesses and electricity supply businesses which may create incentives or opportunities:
 - (i) to inhibit competition in the electricity industry; or
 - (ii) to cross-subsidise generation activities from electricity lines businesses; and
- (b) would not result in relationships between electricity lines businesses and electricity supply businesses which are not at arms length.

In determining exemptions, the Commission will also have regard to the overall purpose of the EIR Act as set out in section 2(1) of the Act. That is, the purpose of the EIR Act is to reform the electricity industry to better ensure that:

- (a) costs and prices in the electricity industry are subject to sustained downward pressure; and
 - (b) the benefits of efficient electricity pricing flow through to all classes of consumers
- by –
- (c) effectively separating electricity distribution from generation and retail; and
 - (d) promoting effective competition in electricity generation and retail.

- 6 Practice Note No.3 states that :

“On receipt of an application in the prescribed form, the Commission will determine whether

² Practice Note No.3, September 1998, Electricity Industry Reform Act 1998 Commission’s Role and Processes.

granting an exemption would be contrary to any element of the particular purpose of Parts 1 to 5 of the EIR Act or the overall purpose of the Act.

The Commission's tests would necessitate obtaining and evaluating objective answers to the following questions in relation to the particular purpose of Parts 1 to 5 of the EIR Act:

- Would the Commission, by granting an exemption in respect of a business or involvement or interest, create incentives or opportunities to inhibit competition in the electricity industry?
- Would the Commission, by granting an exemption in respect of a business or involvement or interest, create incentives or opportunities to cross-subsidise generation activities from electricity lines businesses?
- Would the Commission permit, by granting an exemption in respect of a business or involvement or interest, a relationship between an electricity lines business and an electricity supply business which is not at arms length?

In relation to these questions, the Commission will consider factors such as:

- The relevant market(s)³ within the electricity industry;
- The nature of any incentives or opportunities created;
- The temporal nature of any incentives or opportunities created;
- The nature of any relationship which is not at arms length; and
- The temporal nature of any relationship which is not at arms length.

- 7 Given the particular circumstances of this case, the Commission invited submissions on the Application. The Commission received 10 submissions from various parties including electricity retailers, electricity distribution companies, industry bodies and other interested parties.

PARTIES

The Applicant

Eastland Network Limited (Eastland)

- 8 Eastland is an electricity distribution company servicing the Gisborne and Wairoa districts. It distributes approximately 306GWh of electricity per annum to approximately 26,000 consumers. Eastland is wholly owned by the Eastland Community Trust.

Other Parties

Hydro-Electric Corporation (Hydro Tasmania)

- 9 Hydro Tasmania is based in Hobart and is focused on renewable energy projects, consulting and production. It owns (in Australia) 27 hydro, one gas and two diesel power stations, and two wind farms. In total these assets have a generating capacity of 2568 MW.

Other Interested Parties

- 10 The Commission received submissions on the Application from various parties including Contact Energy Limited, the Major Electricity Users Group, Vector Limited, Mighty River Power Limited, Meridian Energy Limited, MainPower New Zealand Limited, and Genesis Power Limited.

³ Defined using the same process as used for market definitions in respect of Commerce Act matters.

THE PROPOSAL

- 11 Eastland is proposing to construct a 12MW wind farm at Mokairau, approximately 30km north-east of Gisborne. Eastland has submitted that the project is likely to be a 50-50 joint venture with Hydro Tasmania. The two parties have signed a memorandum of understanding.
- 12 Eastland is proposing to retail the generation of the wind farm directly to consumers on Eastland's distribution network. To do this, Eastland wishes to enter into hedge arrangements to ensure a constant revenue stream and also to trade in electricity generally, to enable it to provide a constant supply of electricity. Eastland has also stated, in its application, that it needs to earn a margin on the supply of the electricity sold to justify its investment in the wind farm.
- 13 Eastland submitted that a key reason for needing to invest in the generation is to avoid substantial costs involved in upgrading transmission lines between the local network and the national grid which are presently capacity constrained. Further, Eastland submitted that it has forecast electricity demand to exceed that which can be supplied over the transmission assets, in the near future.
- 14 Eastland also submitted that its proposal is consistent with government policy objectives of meeting increased energy demand and regional economic development in a sustainable, economic and efficient manner. Further, Eastland states that little progress has been made by other parties with respect to investing in embedded generation.
- 15 Eastland states, in its application, that the investment in embedded generation will have the following benefits:
 - provide a commercial return for ENL;
 - avoid the need for transmission capacity upgrades but still ensure that there is adequate electricity supply;
 - provide potential local industry with certainty of competitive electricity price over the long-term;
 - increase the probability of investment in new industry in the region; and
 - augment the national generation portfolio and assist in meeting national energy growth requirements.

APPLICATION OF THE ACT

Electricity Lines Business Involvements

- 16 The definition of "electricity lines business" appears in s4(1) of the EIR Act. That provides as follows:
 4. **Meaning of 'electricity lines business'**
 - (1) For the purposes of this Act, 'electricity lines business'-
 - (a) Means a business that conveys electricity by line in New Zealand; and
 - (b) Includes the ownership or operation, directly or indirectly, of lines in New Zealand or any other core assets of an electricity lines business.
- 17 There are a number of exceptions to this definition in subsection (2):
 - (2) None of the following activities brings a person within subsection (1):
 - (a) Conveying, together with its associates (if any), less than 2.5 GWh per annum:

- (b) Conveying electricity solely for its own consumption or for the consumption of its associates:
- (c) Conveying electricity only from a generator to the national grid or from the national grid to a generator:
- (d) Conveying electricity (other than via the national grid) only from a generator to a local distribution network or from a local distribution network to a generator:
- (e) Conveying electricity by lines that are owned or operated by a business that also owns or operates a generator which generates electricity solely for the consumption of a local community, where both those lines and that generator are not connected, directly or indirectly, to the national grid:
- (f) Conveying electricity only by a line or lines that are mostly in competition with a line or lines operated by another electricity lines business that is not an associate of the person, provided that the competition is actual competition and not potential competition:
- (g) Owning or operating, directly or indirectly, lines referred to in any of paragraphs (a) to (f) or any other core assets of an electricity lines business used in connection with those lines.

18 Eastland falls within the above definition in s4(1)(a) and (b) and is not excepted by s(4)(2). Accordingly, Eastland is considered to be an electricity lines business.

Electricity Supply Business Involvements

19 The EIR Act provides for the definition of “electricity supply business” in s5(1):

5. Meaning of ‘electricity supply business’

- (1) For the purposes of this Act, ‘electricity supply business’ –
 - (a) Means a business that –
 - (i) Sells electricity in New Zealand;
 - (ii) Sells financial hedges for risks relating to the price of electricity in New Zealand;
 - (iii) Generates electricity in New Zealand;
 - (iv) Trades in rights to sell or generate electricity in New Zealand; and
 - (b) Includes the ownership or operation, directly or indirectly, of a generator in New Zealand or any other core generation assets; and
 - (c) Includes the ownership or operation, directly or indirectly, of any core assets of an electricity retail business, which include –
 - (i) The customer data base relating to and used for the purposes of an electricity retail or electricity trading business; and
 - (ii) The benefit of a contract to sell electricity; and
 - (iii) The benefit of an undertaking from any other electricity supply business not to compete with the business.

Subsection (2) provides for a number of exemptions from s5(1):

- (2) None of the following activities brings a person within subsection (1):
 - (a) Selling or generating less than 2.5 GWh per annum:
 - (b) Generating or selling electricity solely for its own consumption or for the consumption of its associates:
 - (c) Generating electricity solely for the consumption of a local community, where -
 - (i) The generator is owned or operated by a business that also conveys electricity by line; and
 - (ii) Both those lines and that generator are not connected, directly or indirectly, to the national grid:
 - (d) Selling electricity that is generated at a generator referred to in paragraph (c) or subsection (3):

- (e) Generating electricity from distributed generation, and selling the electricity generated, where –
 - (i) the generating capacity of the distributed generation is no more, at any one time, than the greater of 5MW (determined according to the nameplate or nameplates) and 2% of the maximum demand, in the immediately preceding financial year, of the system to which the distributed generation is connected; and
 - (ii) the distributed generation is owned or operated by a business that also conveys electricity by line and that distributed generation is connected to those lines:
- (f) Selling financial transmission rights that hedge risks arising from the effects of losses and constraints on the national grid:
- (g) Owning or operating, directly or indirectly, a generator referred to in any of the paragraphs (b) to (f) or subsection (3) or any other core generation assets used in connection with those generators.

20 Through its proposed involvement in the Mokairau Wind Farm Eastland would be deemed to be an electricity supply business by way of s5(1)(a)(i), (ii) and (iii) and also through 5(1)(b), 5(1)(c)(i) and 5(1)(c)(ii).

21 Accordingly, the proposal would result in Eastland being an electricity supply business.

Cross-Ownership Prohibition

22 One of the key intentions of the Act on its inception was to effect ownership separation between electricity supply and electricity lines businesses, as they are defined by the Act. Accordingly, s17 of the Act expressly prohibits such cross-ownership. It provides:

17. Exemption for new generation from new renewable energy source–

- (1) No person involved in an electricity lines business may be involved in an electricity supply business.
- (2) No person involved in an electricity supply business may be involved in an electricity lines business.

Exemption for Generation from New Renewable Energy Source

23 The Act was amended in 2001 by the Electricity Industry Reform Amendment Act 2001 with the intention of relaxing the principle of ownership separation to allow for cross-ownership to exist in particular circumstances with respect to new renewable generation. The amendment, which exists as s46A of the principal Act, was designed to facilitate the investment by lines companies in renewable generation and provides as follows below:

46A. Cross-ownership prohibition –

- (1) The following activities do not cause any person to be in breach of the ownership separation rules:
 - (a) generating electricity from new generation using only-
 - (i) a new renewable energy source; or
 - (ii) a new renewable energy source and fossil fuels if fossil fuels provide no more than 20% of the total fuel energy input for the generator or generators comprising the generation plant in any 12 month period or larger amount approved by the Minister under subsection (3):
 - (b) selling electricity referred to in paragraph (a):
 - (c) owning or operating, directly or indirectly, new generation, or any other core generation assets used in connection with new generation that is capable of generating electricity referred to in paragraph (a).
- (2) Subsection (1) applies only if and as long as sections 24 and 25 are complied with (corporate separation and the arms length rules).
- (3) The Minister may increase the thresholds in subsection (1)(a)(ii) or in paragraph (b) of

the definition of “new renewable energy source” to approve a particular activity for the purposes of subsection (1) (on conditions, if any, he or she thinks fit) after first taking into account whether or not the generation uses new or advanced technology.

(4) In this section-

“New generation” means generation that is not existing on the date on which this section comes into force.

“New renewable energy source” –

(a) means any energy source that occurs naturally and the use of which will not permanently deplete New Zealand’s energy sources of that kind, because those sources are generally expected to be replenished by natural processes within 50 years or less of being used; but

(b) does not include hydro or geothermal energy sources at a generator or generators comprising a generation plant that has an aggregate generating capacity (determined according to nameplate or nameplates) of more than 5 MW, unless approved by the Minister under subsection (3).

(5) This section does not limit section 5(2)(e) (exclusion from definition of electricity supply business).

24 Eastland is proposing to develop a wind farm, which is deemed to be a renewable energy source through s46(A)(4)(a). Accordingly, Eastland is deemed not to be in breach of the cross-ownership provisions (subject to s46(A)(2)) in so far as the proposal relates to:

- the generation of electricity by the wind farm;
- the selling of that electricity; and
- the ownership or operation of the related generation assets.

25 As provided by s46A(2), the exception applies only if the corporate separation and arms length provisions in sections 24 and 25 of the EIR Act are complied with. Further, regardless of the operation of s46A, Eastland, through the proposal, would still be in breach of the cross-ownership prohibition in s17 by way of the hedge arrangements it proposes to enter with purchasers of the electricity generated.

Corporate Separation and Arms Length Rules

26 Section 24 defines what is meant by ‘corporate separation’:

24. Corporate separation–

- (1) Every person that carries on an electricity business that is exempt from complying with the ownership separation rules by reason of ... section 46A (exemption for new...generation from new renewable energy source)...must...carry on its electricity lines business and its electricity supply business in separate companies.

27 Section 25 refers to the requirement to comply with the arms length rules:

25. Arms length rules –

- (1) Every person that is involved in an electricity business that is exempt from complying with the ownership separation rules by reason of ...section 46A (new...generation from new renewable energy source), and any business in which any such person is involved, must...comply, and ensure that that person’s electricity businesses comply, with the arms length rules.
- (2) For that purpose, references in the arms length rules to business A and business B are references only to the electricity lines business and electricity supply business in which the exempt person is involved.
- (3) A transfer that implements a separation for the purposes of section 24 need not be on an arms length basis, but the outcome of the separation must enable compliance with the arms length rules.

28 Schedule 1 of the EIR Act sets out in detail what is meant by arms length separation in s25. It lists a number of rules and principles which must be complied with in order to ensure that the two businesses are operated at arms length. Schedule 1 is attached to this determination as Appendix 1.

The Meaning of Cross Involvement

29 Section 7(1) of the EIR Act provides for the definition of “involved” :

7. Meaning of ‘involved’

- (1) For the purposes of this Act, a person is involved in an electricity business if the person –
- (a) Carries on that business, either alone or together with its associates and either on its own or another’s behalf; or
 - (b) Exceeds the 10% threshold in section 8 in respect of that business; or
 - (c) Has material influence over the business; -
- and ‘involvement’ has a corresponding meaning.

30 Section 11 of the EIR Act provides for the definition of “material influence” :

- (1) Without limiting the ordinary meaning of the expression “material influence”, the following people are deemed to have material influence over an electricity business:
- (a) A manager of a person that carries on the business:
 - (b) If the business is carried on by a natural person, that person:
 - (c) A person in accordance with whose directions, instructions, or wishes a person referred to in either of paragraph (a) or paragraph (b), or the business, may be required or is accustomed to act in respect of the carrying on or management of the business:
 - (d) A person that exercises or that is entitled to exercise, or who controls or is entitled to control the exercise of, powers which would ordinarily fall to be exercised by a person referred to in either of paragraph (a) or paragraph (b):
 - (e) A person that can appoint or remove, or control the appointment or removal of, a person referred to in either of paragraph (a) or paragraph (b):
 - (f) A person that has a power to influence a decision of the business which would ordinarily require the holding of control rights which would cause the person to exceed the 10% threshold:
 - (g) A person in circumstances where that person and the business is acting, or proposing to act, jointly or in concert in relation to the business; or
 - (h) A person that, under a trust or agreement (whether or not the person is a party to it), may at any time have any of the powers referred to in paragraph (c) to paragraph (f).
- (2) Where a person has material influence over an electricity business under this section, and another person has any of the powers or controls referred to in paragraph (c) to paragraph (h) in relation to the first person or the majority of its managers, then that other person is deemed also to have material influence over the business, and so on.(3) A person is deemed to have material influence over an electricity business if the person is one of 2 or more associates who, together, have material influence over the business.
- (4) Subsection (3) does not apply to deem a person to have material influence over a business only because that person is, under section 12(1)(b) or (c), an associate of another person, provided those associates act in accordance with the arms length rules (with all necessary modifications) in respect of the business.
- (5) For the avoidance of doubt, a power to cast one of many votes at an election of trustees or councillors does not, of itself, constitute material influence.

31 The Commission considers that all parties deemed to be involved in both Eastland’s electricity lines business and Eastland’s proposed involvement in an electricity supply business would be deemed to be cross involved themselves. This would extend, but is

not necessarily limited to, the directors of Eastland which, it is proposed, will sit on the board of the electricity supply business.

- 32 If the Commission determined to grant an exemption for the proposal, any such involvements could be disregarded through the operation of s19(1)(h):

19. Certain businesses and involvements to be disregarded

(1) For the purposes of this Act, no account is to be taken of a person's business, or involvement or interest in a business, if- ...

(h) The business, involvement, or interest is exempted by the commission under s81...

- 33 In that event, all otherwise prohibited cross-involvements that would stem directly from the cross-involvement of Eastland could be disregarded for the purposes of this determination.

The Commission's Exemption Power

- 34 Section 81(1) of the EIR Act provides the Commission with a power of exemption:

(1) The Commission may, for the purposes of this Act, in its discretion and upon the terms and conditions (if any) that it thinks fit, by notice in the *Gazette*, exempt—

(a) any business, involvement, or interest, or class of business, involvement, or interest, from the application of this Act; or

(b) any person or class of persons from compliance with any provisions of this Act or any regulations made under it.

Summary of Application of the EIR Act and Cross-Involvements

- 35 The 46A exemption from complying with the ownership separation provisions in s17 is contingent on Eastland complying with:

- the corporate separation provisions in s24; and
- the arms length provisions in s25 and schedule 1.

- 36 The proposal would also breach the ownership separation rules in so far as Eastland wishes to enter into financial hedge arrangements with purchasers of the generated electricity.

- 37 Therefore, Eastland sought an exemption from s25 of the EIR Act to enable it to operate its electricity lines business and manage its investment in the proposed wind farm in a manner that is other than at arms length.

- 38 Eastland has also sought exemption from s5 of the act to enable it to trade in financial instruments (hedges) with purchasers of the electricity generated by the wind farm.

- 39 Eastland has not sought an exemption from the corporate separation rules in s25 and has submitted it will comply with these in respect of its proposed investment in the wind farm.

THE COMMISSION'S EXEMPTION POWER IN RELATION TO S46A

- 40 Given the statutory exemption allowing lines companies to invest in new renewable generation in s46A(1) and the requirement to comply with the arms-length rules in s46A(2), the Commission considered whether it would be appropriate to exercise its discretionary power to applications seeking exemption from compliance with the arms-length rules.

- 41 The Commission's discretionary power to grant exemptions under s81 is in addition to the limited statutory exemption under s46A and the Commission considers that the questions stated in the Commission's Practice Note No.3 continue to be the relevant questions in assessing applications for s81 exemption from the EIR Act and the appropriate questions to address in this case.

EXAMINATION IN TERMS OF THE COMMISSION'S CRITERIA

- 42 The Commission is of the view that the relevant markets in this instance are the national electricity generation market and the regional electricity retail and electricity distribution markets that correspond with the geographic extent of Eastland's electricity lines networks.

Question 1: Incentives or Opportunities to Inhibit Competition in the Electricity Industry

Would the Commission, by granting an exemption in respect of a business or involvement or interest, create incentives or opportunities to inhibit competition in the electricity industry?

- 43 As stated in the Commission's Practice Note No.3, the Commission considers this question in respect of the relevant markets within the electricity industry.
- 44 The relevant markets for the consideration of this application are:⁴
- the regional electricity distribution markets in Gisborne and Wairoa, geographically defined by the boundary of the Eastland's distribution networks in those areas;⁵
 - the national electricity generation and wholesaling market;⁶ and
 - the market for the retailing of electricity in the Gisborne and Wairoa regions.
- 45 The Commission notes that in the past it has generally undertaken assessments of competition in electricity retailing using a national market. This reflects the general ability of retailers to expand readily in different parts of the country, and the fact that competition characteristics are usually similar in most regions. However, the Commission notes that defining markets is not always a precise exercise and, in most instances, markets should be defined in a way that best assists the competition analysis. In this instance the possible competitive harm in retailing from granting Eastland an exemption from the EIR Act would arise only in respect of the region covered by Eastland's network. For this reason, the Commission considers that it is appropriate to use the narrow regional market to undertake its analysis in this case.

⁴ Other markets in the electricity industry, for example the electrical construction and maintenance market and the market for reticulation of new subdivisions, do not appear to be relevant to this application for exemption.

⁵ For discussion of electricity distribution market definition see Decision 345, United Networks Limited / Transalta New Zealand Limited, 11 March 1999 and Decision 299, Holdco (Mercury Energy Ltd and Utilicorp) / Power New Zealand Ltd, 27 June 1997.

⁶ For a discussion of electricity generation market definition see Decision 340, Transalta Corporation of Canada / Contact Energy, 12 February 1999 and Decision 491, Contact Energy Limited / Natural Gas Corporation Holdings Limited, 04 February 2003.

Regional Electricity Distribution Markets

- 46 The regional distribution markets that are relevant to this application are the Gisborne and Wairoa regions, being the regions where Eastland is the network operator.
- 47 Local distribution networks are characterised by being regional, natural monopolies. The granting of this exemption would not affect the level or existing competition or scope for potential competition within those markets.
- 48 Accordingly, the granting of an exemption would not, in respect of these markets, create incentives or opportunities to inhibit competition.

National Electricity Generation and Wholesaling Market

- 49 Eastland submitted that its ownership of wind generation that amounts to less than 0.1% of the total amount of electricity generated nationally on an annual basis and will not provide incentives or opportunities to inhibit competition in respect of this market.
- 50 Eastland is proposing not to sell the electricity it generates through the wholesale market, but rather to retail it to large usage customers located on its network, once the generation is established.
- 51 The Commission considers that the investment in renewable generation will create additional competition, in the national generation and wholesaling market, albeit by a small amount.
- 52 Accordingly, the Commission concludes that the investment in the proposed wind farm is unlikely to create incentives or opportunities to inhibit competition in the national generation market.

Regional Electricity Retail Market

- 53 As stated above, the EIR Act requires separation between electricity distribution functions and electricity retailing in order to protect competition and choice in respect of supply. The EIR Act recognises that an electricity lines business also engaged in retailing has the market power, and may have the incentive, to inhibit competition in electricity retailing. The Commission has previously stated⁷ that lines businesses could do this by:
- charging electricity retailers for access to lines and contract administration more than it charges itself;
 - cross-subsidising its retailing business from its monopoly lines business;
 - delaying or inhibiting access to its lines by its retail competitors.
- 54 Further, submissions of interested parties highlighted additional concerns regarding the lines companies retailing the electricity generated. These concerns included:
- the lines company giving preferential treatment to their own retail customers on the network;
 - the lines company may have information regarding the best customers on its network to the disadvantage of its retailing competitors;
 - lines connections could be slower for non-retail customers;

⁷ See Decision 338, Auckland International Airport Limited, 4 March 1999, at page 9.

- differential treatment in respect of outages; and
 - selectively (to the extent possible) preventing customer transfers.
- 55 In this instance Eastland is proposing to retail the electricity generated to large users on its network.
- 56 In respect of this market Eastland made the following statements in its application:
- ENL no longer has any direct involvement in the national electricity retail market. It is therefore unable to effect competition in this market. Nor would it receive any benefit from inhibiting competition (if it was able to do so). As stated in the Commission's Decision 332, competition in this market is increasing. This is a result of the Government's reforms of the electricity industry and the involvement of new players. ENL's ownership and use of a small amount (on a national or even regional scale) of generation would have minimal effect on this. Retailers are able to compete with each other throughout New Zealand (including the East Coast) unhindered by ENL's proposed generation.
- ENL's interest therefore will not create material incentives or opportunities for ENL to inhibit competition in the national electricity retail market. The purposes of the EIR Act will not be defeated in this market.
- 57 Other submitters referred to the presence of Part 4A of the Commerce Act and a changed regulatory environment since the inception of the EIR Act which remove any incentives or opportunities to inhibit competition that may have existed when the EIR Act was first introduced.
- 58 The Commission acknowledges that the extent to which these effects might occur would be limited by the generation capacity of Eastland and that the proposed generation would constitute less than 12% of the total electricity conveyed over Eastland's networks annually.⁸
- 59 The Commission considers that in this case, to exempt Eastland from the arms length rules would be plainly inconsistent with those rules, and the requirement for compliance in section 46A(2).
- 60 The Commission considers that permitting a lines company to engage in electricity retailing, in a way that is other than at arms length, to consumers on its own network is a matter which can only be addressed, if appropriate, by a change in Government policy and legislation. At this time the Commission considers that the granting of an exemption in this case would create incentives and opportunities to inhibit competition in the Gisborne and Wairoa electricity retail market and that this would be contrary to the purpose of EIR Act as it stands.

Conclusion on Question 1

- 61 The Commission is of the view that in respect of the national electricity generation and wholesaling market, and in respect of the regional⁹ electricity distribution markets the granting of an exemption in this case would not create incentives or opportunities for Eastland to inhibit competition.
- 62 In respect of the Gisborne and Wairoa electricity retailing markets such incentives and opportunities to inhibit competition would be created.

⁸ Including both Eastland's Gisborne and Wairoa network.

⁹ Specifically the Gisborne and Wairoa networks.

Question 2: Incentives or Opportunities to Cross-subsidise Generation Activities

Would the Commission, by granting an exemption in respect of a business or involvement or interest, create incentives or opportunities to cross-subsidise generation activities from electricity lines businesses?

- 63 The Commission considers that a lines business which is also engaged in generation has the opportunity to cross-subsidise its generation business, should it choose to do so. Cross-subsidisation could take a number of forms. It may be that the lines business would meet costs which more properly lie with the generation side of the business. It may be that common costs would all be attributed to the lines business. It may be that the lines business would provide capital to the generation business at less than its true cost. It may be that the generation project would be funded in a way which weakens the financial stability of the lines business.
- 64 Any of these possibilities of cross-subsidisation could increase upward pressure on lines charges.
- 65 The Commission considers that the 50/50 proposed joint venture ownership structure in this instance would weaken the incentive to cross-subsidise, though this is not a factor which, on its own, would remove such incentives altogether. This incentive could arise from a wish to see the overall business expand, possibly by providing a competitive advantage to the generation business. It is possible that an incentive to cross-subsidise would arise from an attempt to make the regulatory regime for lines businesses less effective by 'hiding' lines profits in the generation business.
- 66 The Commission has considered the extent to which incentives or opportunities to cross-subsidise (by way of mis allocation of costs) might be created or increased as a result of granting an exemption. The Commission is of the view that the creation or increase in such incentives or opportunities to cross-subsidise in this way might not be material if only a limited exemption from some arms length rules was granted, whilst requiring compliance with others.
- 67 Further, the Commission considered the extent to which an exemption might enable a direct financial cross-subsidisation between the lines business and generation business or whether such a relationship would enable the lines business to incur risk that would be more properly incurred by the generation business. However, the Commission considers that these opportunities and incentives, to the extent that they exist at present, would not be created by the Commission granting a limited exemption in this instance. This is because the amendment to the EIR Act (section 46A) now allows cross-ownership of lines businesses and renewable generation (such as is proposed by the Applicant), albeit as long as the corporate separation and arms length provisions are complied with. Such ability to cross-subsidise in a direct manner is a consequence of cross-ownership that is authorised by s46A. If a lines company invested in generation and complied with the arms length provisions, no exemption would be required¹⁰, but the risk of cross-subsidisation identified above would still exist.
- 68 Accordingly, the Commission does not consider that an exemption would create or materially increase the incentive or opportunity to cross-subsidise the generation activity proposed by Eastland.

¹⁰ On the assumption that the lines company was not proposing to enter into a hedge arrangement to sell the electricity.

Conclusion on Question 2

- 69 The Commission considers that the granting of an exemption from the arms length rules in this case would not create incentives or opportunities (that did not already exist) to cross subsidise between lines activities and generation activities.
- 70 The Commission considered the extent to which the incentives or opportunities to mis-allocate cost from the generation business to the lines business might be increased as a result of granting an exemption and considers that such incentives or opportunities would not be created or materially increased by granting an exemption from selected arms length rules whilst requiring compliance with others.

Question 3: A Relationship Not at Arms Length

Would the Commission permit, by granting an exemption in respect of a business or involvement or interest, a relationship between an electricity lines business and an electricity supply business which is not at arms length?

- 71 In most circumstances where an exemption is required from the ownership separation provisions of the EIR Act, a relationship will be created that will ultimately not be at arms length. In each case the Commission assesses the practical effect of the non-arms length relationship in order to decide whether that relationship is likely to lead to a result that would be contrary to the purposes of the EIR Act.
- 72 This Application specifically seeks exemption from the necessity to comply with the arms length rules.
- 73 Previously, the Commission has determined that where the granting of an exemption would not create incentives or opportunities to inhibit competition in the electricity industry or would not create incentives or opportunities to cross-subsidise generation activities from electricity lines businesses then the arms length requirement may have no practical effect.
- 74 In this case the Commission is of the view that granting the exemption sought would create incentives and opportunities to inhibit competition in the electricity retail markets in the Gisborne and Wairoa regions. Those effects are discussed in consideration of the Commission's first question above.

Conclusion on Question 3

- 75 The Commission is of the view that, in this situation, an exemption would create a relationship that is not at arms length and would have practical consequences in facilitating the anti-competitive effects identified under the Commission's first question, in relation to expanded opportunities or incentives to inhibit competition.

Other considerations

- 76 Eastland submitted that this investment would allow it to avoid large costs that would otherwise be incurred through the necessity of upgrading the transmission assets connecting the Eastland distribution network to the national transmission grid. Eastland also submitted that little interest had been shown to date by retailers of electricity in investing in generation to ease these constraints. Whilst the Commission considers that these concerns might be genuine, they are largely irrelevant for the Commission in considering an exemption from the arms-length provisions in this case as they do not go

to the purposes of the Act, which are addressed by the Commission's three questions above.

- 77 In Decision 503 the Commission granted an exemption to Eastland to own generation for the purpose of managing its peak load. In that case, an exemption was granted despite two of the Commission's three criteria not being met. The Commission had regard to the overall purpose of the Act, and considered that a fundamental objective (that costs and prices in the electricity industry are subject to sustained downward pressure) would be better advanced if an exemption was granted than if it were declined. This was because the alternative would have involved the necessity to upgrade transmission lines connecting to Eastland's network, which would have resulted in upward pressure on electricity lines prices.
- 78 The Commission does not consider that the considerations are the same in this case. The exemption sought is from the arms length provisions of the EIR Act and for the ability to trade in hedges. It would be open to Eastland to avoid the cost of transmission upgrades while still observing these rules, or amending its proposal such that the anti-competitive effects, identified above, are eliminated.

Conclusion in Respect of the Commission's Criteria

- 79 The Commission considers that granting an exemption to Eastland to enable it to undertake the proposal outlined in its Application would:
- create incentives and opportunities to inhibit competition in the electricity retail market in the Gisborne and Wairoa region; and
 - permit a relationship between an electricity lines business and an electricity supply business which is not at arms length.
- 80 The Commission considers that the authorisation by s46A of cross-involvement between lines and supply businesses means that the risk of cross-subsidisation between lines activities and generation activities, would not be created or materially increased by the granting of a limited exemption from selected arms length rules.
- 81 The Commission is of the view that the potential anti-competitive consequences in the electricity retail markets are consequences designed to be prevented by the EIR Act on its inception and remain in place.
- 82 In conclusion, for the above reasons, the Commission declines to grant an exemption from the EIR Act to Eastland.

THE COMMISSION'S DETERMINATION

83 The Commission determines to decline to grant an exemption to Eastland from sections 5 and 25 of the EIR Act.

Dated this 15th day of March 2006

Paula Rebstock
Chair
Commerce Commission

APPENDIX 1

ARMS LENGTH RULES

1. Objective—

- (1) The objective of this schedule is to ensure that where—
 - (a) Persons carrying on an electricity business or businesses, and any common parent of those businesses, have not complied with the ownership separation rules:
 - (b) A settling trust and a mirror trust are involved in electricity businesses,—the electricity lines business and electricity supply business and, in the case of paragraph (b), the settling trust and the mirror trust, operate at arms length.
- (2) Without limiting the ordinary meaning of the expression, "arms length" includes having relationships, dealings, and transactions which—
 - (a) Do not include elements that parties in their respective positions would usually omit; or
 - (b) Do not omit elements that parties in their respective positions would usually include,—
 if the parties were—
 - (c) Connected or related only by the transaction or dealing in question; and
 - (d) Acting independently; and
 - (e) Each acting in its own best interests.

2. Arms length rules—

The arms length rules are as follows:

Duty to Ensure Arms Length Objective Is Met

1. Business A and every parent of business A, and business B and every parent of business B, must take all reasonable steps to ensure that the arms length objective in clause 1 is met.

Arms Length Terms

2. Business A, and every parent of business A, must not enter into a transaction in which business B, or any parent of business B, is interested if the terms of the transaction are terms which unrelated parties in the position of the parties to the transaction, each acting independently and in its own best interests, would not have agreed to.

Duty Not to Prefer Interests of Business B

3. A manager of business A must not, when exercising powers or performing duties in connection with business A, act in a manner which the manager knows or ought reasonably to know would prefer the interests of business B over the interests of business A.

Duty Not to Discriminate in Favour of Business B

4. Business A must not, in providing services or benefits, discriminate in favour of business B or the customers, suppliers, or members of business B.

Duty to Focus on Interests of Right Ultimate Owners

5. A manager of business A must, when exercising powers or performing duties in connection with business A, act in the interests of the ultimate members of business A in their capacity as such, and must neither subordinate the interests of those members to the interests of the members of business B nor, to the extent that the members or ultimate beneficial members of each business overlap, take account of that fact or have regard to their dual capacity as members of business B and business A.

Duty of Managers of Parents of Business A

6. A manager of a parent of business A must not, when exercising powers or performing duties in connection with business A, act in a manner which the manager knows or ought reasonably to know would prefer the interests of business B, or of the customers, suppliers, or members of business B in that capacity, over the interests of business A or the customers, suppliers, or members of business A.

Requirement for Separate Management

7. A manager of business A must not be a manager of business B.
8. A manager of business A must not be an associate of business B, other than by virtue of being a manager of business A.
9. A manager of business A must not be involved in the business of business B.
10.
 - (1) Subject to subclause (2), no person may place the manager of business A under an obligation, whether enforceable or not, to act in accordance with the directions, instructions, or wishes of business B, or any manager or associate of business B, or any parent of business B, and no manager may submit to any such obligation.
 - (2) A common parent of both business A and business B may place a manager under such an obligation if doing so does not contravene another of the arms length rules.

Restriction on Use of Information

11. Business A must not disclose or permit the disclosure to business B, or use or permit the use for the purposes of business B of, restricted information of business A.

An electricity trust that is a parent of business A (trust A), business A, and every parent of trust A, must not disclose or permit the disclosure to business B, an electricity trust that is a parent of business B (trust B), or any parent of trust B, or use or permit the use for the purposes of business B or trust B, of restricted information of business A or trust A.

“Restricted information” is information received or generated, and held, by business A or trust A connected with its business, being information which—

- (a) Is not available to the competitors or potential competitors of business B or trust B; and
- (b) If disclosed to business B or trust B, would put, or be likely to put, business B or trust B in a position of material advantage in relation to any competitor or potential competitor.

Records

12. Every business to which this schedule applies must keep at its registered office a register of transactions entered into between business A, or any parent of business A, and business B, or any parent of business B.
13. Business A must, within 10 working days of entering into any such transaction, enter in its register details sufficient to identify the nature and import of the transaction.

Practical Considerations

14. Business A and every parent of business A must ensure that its practical arrangements, such as use of accommodation, equipment, and services, do not contravene this schedule.
 15. Business A and every parent of business A must ensure that its selection and appointment of advisors does not prejudice compliance with rules 7 to 11.
3. Rules do not limit objective—
The arms length rules in clause 2 do not limit the generality of the arms length objective in clause 1.
 4. Interpretation—
 - (1) In this schedule,—
 - (a) ``Parent'', in relation to a business, means every person that is involved in the business:
 - (b) ``Common parent'', in relation to business A and business B, means a person that is involved in both business A and business B.
 - (2) In this schedule, a person is ``interested'' in a transaction if the person, or an associate of that person,—
 - (a) Is a party to, or will derive a material financial benefit from the transaction; or
 - (b) Has a material financial interest in a party to the transaction; or
 - (c) Is a manager of a party to, or a person who will or may derive a material financial benefit from the transaction; or
 - (d) Is otherwise directly or indirectly materially interested in the transaction.
 - (3) References in this schedule to business A or trust A apply equally to business B or trust B and vice versa.
 5. Terms refer only to related companies—
The terms ``business A'' and ``business B'' refer to electricity lines businesses and electricity supply businesses—
 - (a) Which are carried on by electricity companies in which a mirror trust and its settling trust are involved; or
 - (b) Which are carried on by electricity companies which have a common parent.
 6. These duties are additional to other duties—
The requirements of this schedule are additional to the requirements of the Electricity (Information Disclosure) Regulations 1994 and any other regulations from time to time made under the Electricity Act 1992.