



COMMERCE COMMISSION

Decision No. 352

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

THE NEW ZEALAND DEFENCE FORCE

The Commission:

K M Brown
E M Coutts
E C A Harrison
P R Rebstock

Commission Staff:

D R Ainsworth
A J Brice

**Summary of
Application:**

The New Zealand Defence Force, which is involved in an electricity lines business and an electricity supply business, seeks an exemption, pursuant to section 81 of the EIR Act, from the application of the EIR Act.

Determination:

The Commission, pursuant to section 81 of the EIR Act, exempts the New Zealand Defence Force from the application of section 17 of the EIR Act in relation to a prohibited cross-involvement in an electricity lines business and an electricity supply business. The exemption is subject to the conditions stated in this Decision.

Date of Determination:

28 April 1999

Date of Exemption:

On publication of the Notice of Exemption in the *Gazette*

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INTRODUCTION

- 1 On 30 March 1999 the Commerce Commission (the Commission) received an application from the New Zealand Defence Force for exemption from the application of the EIR Act.
- 2 The Commission's powers to exempt businesses, involvements or interests from the application of the EIR Act or persons from compliance with any provisions of any regulations made under the EIR Act are specified in section 81 of the EIR Act.

THE NEW ZEALAND DEFENCE FORCE

- 3 The New Zealand Defence Force (NZDF) comprises the armed forces and civilian staff of the New Zealand Naval Forces, the New Zealand Army and the Royal New Zealand Airforce divided into such branches or corps, formations, commands, units, and other parts as the Chief of Defence Force determines.¹
- 4 NZDF has nine major army, naval and airforce bases.² In addition there are numerous smaller installations, camps and buildings throughout New Zealand.

NZDF's Electricity Lines Business

- 5 NZDF owns and operates a number of electricity distribution networks (networks) throughout New Zealand. Its large bases are reticulated with 11,000/400 volt networks and its smaller installations with 400 volt networks. NZDF takes its electricity supply from local electricity companies and distributes it throughout its bases. NZDF conveys approximately 80 GWh per annum over its various networks.

NZDF's Electricity Supply Business

- 6 NZDF has a nation-wide electricity purchase contract with Genesis Power Ltd (which purchased the electricity retailing business of Powerco Ltd, NZDF's former supplier). The contract expires in July 2000. At that time NZDF intends to seek tenders for its electricity supply for a further two years.
- 7 NZDF supplies electricity to three companies, which operate on the sites of the Devonport, Trentham and Woodbourne bases and which are suppliers of services to the navy, army and airforce:
 - NZDF supplies approximately 2.7 GWh per annum of electricity to Babcock New Zealand Ltd (Babcock) at Devonport Naval Base. Babcock provides warship maintenance services to the New Zealand Navy.
 - NZDF supplies approximately 0.7 GWh per annum of electricity to Serco Project Engineering Ltd (Serco) at Trentham Army Camp. Serco provides mechanical equipment maintenance and warehousing services to the New Zealand Army.

¹ Section 11 Defence Act 1990.

² At Devonport (Navy); Waiouru, Linton, Trentham and Burnham (Army); and Whenuapai, Hobsonville, Ohakea and Woodbourne (Airforce).

- NZDF supplies approximately 3.5 GWh per annum of electricity to Safe Air Ltd (Safe Air) at Woodbourne base. Safe Air provides aircraft maintenance services to the Royal New Zealand Airforce. NZDF also supplies approximately 0.05 GWh per annum to Serco at Woodbourne. Serco provides building maintenance services to the airforce.
- 8 Babcock, Serco and Safe Air are supplied with electricity by NZDF at prices which equate to those which NZDF itself pays its own electricity and line function service providers. NZDF adds no margin onto those prices in its charges to the three companies.
- 9 NZDF also supplies approximately 0.5 and 0.8 GWh per annum of electricity to its own staff who live at 62 and 114 staff houses at Ohakea and Whenuapai airforce bases respectively. In the case of the Ohakea staff consumers, NZDF adds a margin to its own costs when determining the staff electricity charges. In the case of the Whenuapai staff consumers, NZDF does not mark up its own electricity costs in determining the staff electricity charges.
- 10 There are also numerous small electricity consumers connected to the networks at NZDF's bases who receive their electricity from the NZDF for no charge. Examples of this type of consumer are contractors who operate the messes and canteens at the bases, hairdressers, private medical practitioners and retail shop owners. However, in respect of these consumers, NZDF is not an electricity supply business as it does not sell electricity in New Zealand (section 5(a)(i)).³
- 11 NZDF operates a number of electricity generators. This equipment can be divided into several classes:
- emergency generators installed on its bases to allow certain essential facilities to continue functioning in the event of disruptions to electricity supplied from the national grid or local lines companies. These generators only operate in the event of electricity supply disruptions;
 - mobile generators used to supply electricity to field operations;
 - the electricity generators on board the navy's warships; and
 - small generators which are connected to the airforce's aircraft whilst on the ground for the purpose of starting engines.
- 12 NZDF has informed Commission staff that the total capacity of such generators exceed a nameplate capacity of five megawatts but that these generators are currently used exclusively to supply electricity for NZDF consumption.

³ A sale is an exchange of a commodity for money or other valuable consideration (Oxford Dictionary).

INVOLVEMENTS

Electricity Lines Business

- 13 NZDF is the owner of networks. In terms of the EIR Act it:
- owns a business that conveys electricity by line in New Zealand (s4(1)(a));
 - owns and operates, directly, lines in New Zealand and other core assets of an electricity lines business (s4(1)(b)); and
 - has no activities excluded from the definition of an electricity lines business by section 4(2).
- 14 Therefore NZDF is an electricity lines business in terms of the EIR Act. NZDF agrees with this interpretation.
- 15 NZDF:
- carries on an electricity lines business alone (s7(1)(a));
 - exceeds the 10% threshold in terms of control rights in that business (s7(1)(b)); and
 - has material influence over that business (s7(1)(c)).
- 16 Therefore NZDF is involved in an electricity lines business in terms of the EIR Act.

Electricity Supply Business

- 17 NZDF in terms of the EIR Act:
- sells electricity in New Zealand (s5(1)(a)(i));
 - generates electricity in New Zealand;
 - owns and operates directly generators in New Zealand;
 - owns and operates directly core assets of an electricity retail business which include the benefit of contracts to sell electricity (s5(1)(c));
 - is excluded from the definition of an electricity supply business in respect of its generation of electricity and ownership and operation of generators because it generates electricity solely for its own consumption (5(2)(b)); and
 - has no other activities excluded from the definition of an electricity supply business by section 5(2).
- 18 Therefore NZDF is an electricity supply business in terms of the EIR Act. NZDF agrees with this interpretation.
- 19 NZDF:
- carries on an electricity supply business alone (s7(1)(a));
 - exceeds the 10% threshold in terms of control rights in that business (s7(1)(b)); and
 - has material influence over that business (s7(1)(c)).
- 20 Therefore, NZDF is also involved in an electricity supply business in terms of the EIR Act.

PROHIBITED CROSS-INVOLVEMENT

- 21 Section 16 of the EIR Act binds the Crown⁴. The EIR Act therefore applies to NZDF.
- 22 Section 17 of the EIR Act provides:
- “(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.”
- 23 NZDF is involved, and wishes to remain involved, in both an electricity lines and an electricity supply business. NZDF has, in terms of section 17 of the EIR Act, a prohibited cross-involvement.
- 24 NZDF has therefore, applied to the Commission for exemption from the application of the EIR Act and, in particular, from the requirement to comply with the ownership separation provisions of the EIR Act.

COMMISSION PROCEDURES

General

- 25 For the purpose of considering this application for exemption, the Commission, pursuant to section 58 of the EIR Act which applies section 105 of the Commerce Act 1986 to the EIR Act, has delegated its powers under section 81 of the EIR Act to K M Brown, E C A Harrison, E M Coutts and P R Rebstock.
- 26 The Commission’s decision is based on an investigation conducted by its staff and their subsequent advice to the Commission.
- 27 During their investigation into this application for exemption, Commission staff interviewed and obtained information from:
- Babcock;
 - Serco;
 - Safe Air; and
 - NZDF personnel at Devonport, Woodbourne and Wellington Headquarters.

Criteria Used by the Commission to Consider Exemption Applications

- 28 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.3.5
- 29 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

⁴ Except in so far as the Crown owns Transpower Ltd and electricity supply businesses. That exception is not relevant to NZDF’s application for exemption.

⁵ Practice Note No.3, September 1998, Electricity Industry Reform Act 1998 Commission’s Role and Processes.

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.”

30 The Commission noted in Practice Note No.3 that:

“...the EIR Act provides for maximum cross-ownership limits and specific structural and behavioural requirements to ensure that the purposes of the Act are met. Strict compliance with these limits and requirements is, other than in exceptional circumstances,⁽⁶⁾ expected.”

31 The Commission stated in Practice Note No.3 that:

“On receipt of an application in the proscribed form, the Commission will determine whether 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 three 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:

- Relevant market(s)⁷ 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.”

⁶ For example, of the types provided for in section 19 of the EIR Act.

⁷ Defined using the same process as used for market definitions in respect of Commerce Act matters.

RELEVANT MARKET

- 32 The national electricity retail market is relevant to the application of the Commission's criteria to the facts of NZDF's application for exemption.⁸

NZDF'S ARGUMENTS

- 33 NZDF states that it is not a commercial entity which must operate at a profit. It does, however, wish to reduce its costs and has begun to outsource non-core activities associated with defence operations. Hence the arrangements it has with Babcock, Serco and Safe Air to provide services to the NZDF, which were formerly provided by its own staff.
- 34 The arrangements between NZDF and those three parties include provision for NZDF to supply electricity and that payment for such is required.
- 35 NZDF is a large purchaser of electricity for its own use. It states that the purchasing power resulting from its 80 GWh per annum supply contract is such that it has obtained very favourable prices for electricity as part of this national supply contract.
- 36 NZDF states that it is in its interests to provide Babcock, Serco and Safe Air and any future additional contractors with the lowest priced electricity possible. It argues that higher operating costs, in the form of electricity charges, would merely be charged back to the NZDF as increased labour rates for the service the contractors perform.
- 37 As a consequence NZDF supplies electricity to Babcock, Serco and Safe Air with no margin added to its own electricity purchase and electricity line charge costs. Further, NZDF does not charge for the use of NZDF's networks at its bases, for electrical losses which occur on the NZDF owned networks or to recover the cost of administration time and metering and computer monitoring equipment installed by NZDF to allow it to supply electricity to the three consumers. It therefore argues that it provides electricity to the contractors at below its cost and certainly well below the cost at which the contractors could independently obtain electricity supply. It believes that if it were required, by the ownership separation provisions of the EIR Act, to cease supplying its contractors with electricity, that would have the effect of increasing its costs.
- 38 Commission staff have spoken to Babcock, Serco and Safe Air and all are satisfied with their electricity supply arrangements.
- 39 In respect of the staff electricity consumers at Ohakea and Whenuapai, it is only at Ohakea that NZDF supplies consumers at a margin above its costs. NZDF states that the reason for this is to equalise the electricity charges between those staff living on-base and those living off-base and that the margin is applied in such a manner that this occurs.

⁸ Other markets in the electricity industry, for example local distribution markets, wholesale electricity market, the electrical construction and maintenance market and the market for the reticulation of new subdivisions, do not appear to be relevant to this application for exemption.

EXAMINATION IN TERMS OF THE COMMISSION'S CRITERIA

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?

- 40 The focus of the following analysis is on that part of the national electricity retail market comprising NZDF's contractor and staff consumers at its bases and whether an exemption would provide NZDF with incentives or opportunities to inhibit competitive electricity supply to them.
- 41 The Commission notes NZDF's argument that it is not a commercial entity. However, the EIR Act defines the activities of an electricity lines business and an electricity supply business. Where activities fall within these definitions, the EIR Act will apply regardless of whether the purpose of the entity is commercial or non-commercial.
- 42 The Commission considers that NZDF has incentives to provide electricity at low prices to Babcock, Serco and Safe Air as electricity pricing affects NZDF's own costs. These incentives would not be changed by the granting of an exemption. Any increase in electricity price would be passed back to NZDF.
- 43 Indeed, in the light of NZDF's statement that, given its electrical losses on its networks, administration and capital costs, it sells electricity to the relevant consumers at a loss to itself, NZDF would have incentives to promote the replacement of itself as retailer, providing the new retailer could supply the relevant consumers at the same or lower electricity prices. If NZDF attempted to prevent another retailer from supplying by not entering into a use-of-systems agreement for its networks, NZDF would be at risk under both the Commerce Act and the EIR Act.
- 44 With regard to NZDF's staff consumers at Ohakea and Whenuapai, NZDF does have the incentive and opportunity to inhibit competitive electricity supply to those consumers. NZDF has an incentive to protect the margin it earns on charges to these consumers (or potential margin it might earn in the case of Whenuapai). NZDF has such an opportunity through its ability to set line charges and access terms for any competing retailer seeking access over the electricity distribution networks at the two bases.
- 45 The Commission considers that, except in the case of its electricity supply to staff consumers at Ohakea (and potentially Whenuapai), NZDF's incentives and opportunities to inhibit competitive electricity supply are no more than minimal. The Commission concludes that, the Ohakea and Whenuapai situations aside, the granting of an exemption from the application of the EIR Act, and in particular the requirement to comply with the ownership separation provisions will not provide NZDF with incentives or opportunities to inhibit competition in the national electricity retail market.

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?

- 46 For the purposes of the EIR Act, Parliament has decided that generating electricity solely for a person's own consumption or the consumption of its associates should be disregarded.⁹
- 47 While NZDF does have emergency and other generators, it appears all electricity generated by NZDF is currently for its own consumption. Therefore, this criterion is not relevant to the Commission's decision at present.
- 48 However, it is possible that at some future times, NZDF's electricity generators may be used to supply electricity to other than itself during emergencies affecting a non-military population. The Commission does not consider the use of NZDF's generators in such a situation would provide NZDF with incentives or opportunities to cross-subsidise generation activities from its electricity line business.

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?

- 49 NZDF proposes to continue to own and operate both an electricity lines business and an electricity supply business. The two businesses will have common managers, premises and records. Managers will make decisions about both line and supply pricing and also about the terms for the granting of access to NZDF's network by electricity retailers who wish to compete with NZDF's electricity supply business. The relationship between NZDF's electricity lines and supply businesses will not be at arms length.
- 50 However the Commission considers that the potential effects of the relationship not being at arms length can be tempered by the fact that NZDF supplies line function services, to all the consumers it supplies with electricity, at no charge. It is in this respect, restricted in its ability to use the existence of a relationship not at arms length to defeat the purposes of the EIR Act. As a result, the Commission does not consider the potential effects of the relationship not being at arms length to be a material risk to the purposes of the EIR Act.

⁹ Section 5(2)(b).

THE COMMISSION'S DECISION

- 51 NZDF's application fails the first of the Commission's criteria, only in respect of electricity supply to NZDF's staff houses at Ohakea and Whenuapai. However, the Commission accepts that NZDF can eliminate its incentives and opportunities by way of a condition attached to any exemption the Commission might otherwise, be minded to grant.
- 52 The second criterion does not apply to NZDF's application at present, but if it did become relevant in the event of future civilian emergencies, it would likely pass the Commission's test.
- 53 NZDF's application passes the third criterion used by the Commission to decide upon exemptions from the EIR Act.
- 54 In making its decision the Commission notes that the facts revealed in NZDF's application are particular to its situation alone. The Commission also notes that section 81(5) provides that the Commission may vary or revoke any exemption at any time.
- 55 Therefore, having considered the stated criteria, the Commission exempts NZDF from the application of section 17 of the EIR Act, subject to the terms and conditions specified in the Notice of Exemption.

NOTICE OF EXEMPTION

The Commission, pursuant to section 81 of the Electricity Industry Reform Act 1998, exempts the New Zealand Defence Force from the application of section 17 of that Act in relation to a prohibited cross-involvement in an electricity lines business, being the electricity distribution networks owned and operated by the New Zealand Defence Force on its bases, installations and sites and an electricity supply business operated by it.

The exemption is subject to the following terms and conditions:

- (a) That if the New Zealand Defence Force commences supplying line function services or electricity to other than its staff or to Safe Air Ltd, Babcock New Zealand Ltd and Serco Project Engineering Ltd or their assigns it notifies the Commission.
- (b) That the New Zealand Defence Force generates electricity only for its own consumption except in the event of an emergency affecting a non-military population.
- (c) That the New Zealand Defence Force advises the Commission of any increases or new charges which comprise any component of the electricity price it charges to its staff or to Safe Air Ltd, Babcock New Zealand Ltd and Serco Project Engineering Ltd or their assigns or any other person.
- (d) That the New Zealand Defence Force does not introduce a charge for the use of its electricity lines business to any of the consumers it supplies with electricity.
- (e) That the New Defence Force:
 - removes the margin it presently adds to its own electricity and lines costs for electricity supply to Ohakea base in order to calculate the electricity price to staff consumers at Ohakea;
 - charges Ohakea staff consumers on a revised basis using NZDF's own average electricity costs at Ohakea base;
 - advises the Commission of the details of the revised basis of charging the Ohakea staff consumers; and
 - retains the current methodology used to determine Whenuapai staff consumer electricity charges.

The Commission may vary or revoke this exemption in accordance with section 81(5) of the EIR Act.

The exemption takes effect from the date of publication of this Notice in the Gazette.

Dated this 28th day of April 1999

The Commission