

BABCOCK AND BROWN INTERNATIONAL PTY LTD**APPLICATION FOR EXEMPTION UNDER SECTION 81 OF THE
ELECTRICITY INDUSTRY REFORM ACT 1998**

Date: 4 October 2007

Applicant: Babcock & Brown International Pty Ltd
Level 23, The Chifley Tower
2 Chifley Square:
Sydney NSW

Attention: Ben Bolot

Tel: (0061) 2 9229 1517
Fax: (0061) 2 9223 2496

Email: ben.bolot@babcockbrown.com

Applicant's contact: c/- Chapman Tripp
10 Customhouse Quay
PO Box 993
Wellington

Attention: Andy Nicholls/Stacey Thompson

Tel: (04) 499 5999 / (04) 498 2406
Fax: (04) 472 7111

Email:
andy.nicholls@chapmantripp.com
stacey.thompson@chapmantripp.com

Application: Pursuant to section 81 of the Electricity Industry Reform Act 1998 (*EIRA*), application is hereby made to the Commerce Commission for exemption from the application of the *EIRA*.

Introduction

- 1 Babcock & Brown International Pty Ltd (*B&B*) will be involved in a supply business for the purposes of EIRA, by virtue of its links with the Te Rere Hau wind farm. The wind farm is under construction, but when it is completed it will satisfy the definition of a supply business.
- 2 B&B is also technically involved in Glenbrook power station. While B&B only has 9.34% of the shares of BBP, the owner of Glenbrook, when the shareholding of associates is taken into account this rises to 10.34%. This is just over the 10% threshold for involvement in BBP.
- 3 While Glenbrook meets the definition of supply business, it is embedded in the NZ Steel steelworks and all output is contracted to and used by the steel works.
- 4 B&B also narrowly crosses the EIRA threshold for involvement in Babcock & Brown Infrastructure Limited (*BBI*), the corporate parent of Powerco. B&B has only a 8.2% shareholding in BBI. However minor shareholdings in BBI by entities that are technically associates of B&B bring the total shareholding to 10.3% of BBI – again, just over the 10% threshold for involvement.
- 5 B&B applies for an exemption for this involvement in BBI.
- 6 Two directors of BBI are involved with B&B – one as a director of B&B and one as a senior manager. For this reason, B&B applies for an exemption from section 17 on the condition that it comply with the Arms Length and Corporate Separation rules, except for rules 7-10 of the Arms Length Rules.

Applicant

- 7 The applicant is B&B, a global investment and advisory firm specialising in structured finance and the creation, syndication and management of asset and cash flow-based investments. B&B was founded in 1977. Its parent entity Babcock & Brown Limited is listed on the Australian Securities Exchange (*ASX*).
- 8 B&B has two electricity generation interests in New Zealand, which are discussed below.

Te Rere Hau wind farm
- 9 B&B owns 50% of an Australian company, NPBB Pty Limited (*NPBB*), with NP Power Pty Limited.
- 10 NPBB has entered into an unincorporated joint venture to develop Te Rere Hau wind farm north of Palmerston North, with New Zealand based NZ Windfarms Limited (*NZWL*), a wind farm development and electricity generation business which is listed on the New Zealand Stock Exchange.

- 11 Te Rere Hau is a 48.5 MW wind farm being constructed on the Tauranga Ranges near Palmerston North. The project is estimated to cost approximately \$80 million. Vector Limited (a lines business for the purposes of the EIRA) recently acquired a 19.992% equity interest in NZWL via a capital raising for that business. Vector has been granted an exemption from the EIRA in relation to its involvement in Te Rere Hau.
 - 12 Five of the proposed 97 wind turbines have been constructed to date. A further 14 turbines are scheduled to be erected over the coming summer. The capacity of the windfarm is currently less than 2.5Gwh per annum.
 - 13 The wind farm is operated by NZWL under a Management Services Agreement. Under this agreement, NZWL is responsible for the management of the wind farm during its construction and operational phases including operating and maintaining the wind turbine generators, managing relationships with other parties and marketing and selling the output and any carbon credits from the wind farm.
- Glenbrook power station*
- 14 B&B holds 9.34% of the stapled securities of Babcock & Brown Power Limited and Babcock & Brown Power Trust which together comprise the ASX listed entity Babcock & Brown Power (BBP). B&B directors have minor shareholdings in BBP totalling 1%. This brings B&B and its associates' shareholdings to just over the 10% threshold for involvement in BBP (and therefore Glenbrook) under the EIRA.
 - 15 BBP is a specialist infrastructure entity which provides investors access to an electricity generation portfolio.
 - 16 BBP has acquired the Glenbrook power station (*Glenbrook*) as part of the acquisition by a consortium of Alinta Limited. A separate application for exemption from the EIRA was made to the Commission by Babcock & Brown Infrastructure (BBI), in relation to procedural issues around the acquisition of Glenbrook.
 - 17 Glenbrook is a 112 MW cogeneration power plant, comprising the Kilns Cogeneration Plant, which came online in 1997, and the Multi-Hearth Furnace Cogeneration Plant, which was commissioned in 1987. It is the main supplier of electricity and steam to New Zealand Steel for use in the Glenbrook steelworks.
 - 18 The Kilns plant is technically connected to the national grid through New Zealand Steel's connection arrangements with Transpower. However, Glenbrook does not export any electricity to the national grid. The MHF plant is integrated into the steelworks' electricity reticulation system.

- 19 Glenbrook is fully integrated with the steelworks. Both plants rely on "off gases" from the steelmaking process as their fuel source. The output of Glenbrook is therefore dependent on the level of the production processes at the steelworks for the various gases that are used to fuel the generation units. The Glenbrook plant cannot be operated independent of the steelworks.
- 20 All output is contracted to, and used by, the steel works. Glenbrook currently supplies approximately 60% of the electricity requirements of the steelworks, with New Zealand Steel currently supplementing the power it receives from Glenbrook with power purchased from the national electricity market. Glenbrook has no ability to influence power prices in this market.
- 21 For these reasons, while Glenbrook meets the technical definition of an electricity supply business in the EIRA, it does not give rise to the concerns that the EIRA addresses.

Babcock & Brown Infrastructure

- 22 BBI is a stapled entity listed on the ASX and is comprised of Babcock & Brown Infrastructure Limited and Babcock & Brown Infrastructure Trust. BBI is a specialist infrastructure entity which provides investors access to a diversified portfolio of quality infrastructure assets. BBI has investments in energy distribution and transport infrastructure assets in Australia, Europe and North America.
- 23 BBI owns 100% of BBI Networks (New Zealand) Limited (*BBI NZ*). BBI NZ is the owner of Powerco, New Zealand's second largest electricity and gas distribution business. BBI is therefore involved in a lines business for the purposes of the EIRA.
- 24 BBI is listed on the ASX and the NZX and is generally widely held. B&B has a small ownership interest of 8.2% in BBI.
- 25 B&B seeks an exemption for its involvement in BBI.

Application of the EIRA

B&B

- 26 Section 17 of the EIRA prohibits the cross involvement between electricity lines and electricity supply businesses.
- 27 "Involved" is defined in section 7 of the EIRA:

- (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.

28 Section 5(1) of the EIRA provides that:

(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.

29 B&B is therefore involved in two electricity supply businesses:

- 29.1 Te Rere Hau wind farm – through B&B's 50% ownership of NPBB, the Australian company that in turn owns 50% of Te Rere Hau; and
- 29.2 Glenbrook – through its 10.34% ownership of BBP (when the impact of associates is taken into account).

30 Section 4 of the EIRA provides that:

(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.

(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:

31 Powerco conveys electricity by line in New Zealand and is accordingly an electricity lines business under section 4 of the EIRA.

32 B&B's 8.2% interest in Powerco (through BBI and BBI NZ) does not cross the 10% threshold established in section 7 of the EIRA. However, section 8 of the EIRA provides that a person exceeds the 10% threshold in respect of an electricity business if the person is one of two or more associates who, in aggregate, have more than 10% of the control rights (or equity return rights) in the business.

33 In turn, "associates" is defined in section 12 of the EIRA as including directors and related body corporates.

34 Associates of B&B own the following shareholdings in BBI:

34.1 Phillip Green (a director of both Babcock & Brown Limited and BBI) - 0.96%;

34.2 James Babcock (Babcock & Brown Limited's executive chairman) - 0.70%; and

34.3 Everest Babcock & Brown (of which B&B owns 30%) - 0.44%.

35 The aggregate control rights of B&B and its associates in BBI take B&B's shareholding in BBI just over the 10% threshold. This means that B&B is technically involved in BBI, which is involved in an electricity lines business, and therefore B&B is cross involved in terms of section 17 of the EIRA.

Management contract

36 A management contract exists between BBI and Babcock & Brown Infrastructure Management Limited (*BBIM*), whereby BBIM provides management services to BBI. BBIM is a 100% owned B&B subsidiary.

- 37 This raises the question whether B&B is also "involved" in BBI due to the management contract in place between BBIM and BBI. Under section 7 of the EIRA, a person is involved in an electricity business if they have material influence over that business.
- 38 Section 11 of the EIRA provides that a person in accordance with whose directions, instructions or wishes an electricity business may be required to act in respect of the carrying on or management of the business is deemed to have "material influence" over that business.
- 39 The terms of the management contract provide that that BBI may not make any decision, take any action or omit to take any action in relation to a matter, unless that matter has been the subject of a recommendation by the Manager, or it would be a breach of law to act or not act in that way. This means that BBIM has material influence over BBI for the purposes of the EIRA.
- 40 However, the BBIM management contract does not give B&B the ability to direct the actions of BBI. BBIM is required to manage BBI in the best interests of BBI. Importantly, BBI owns a wide variety of infrastructure assets. All must be managed by BBIM in the best interests of BBI. To focus on the issues relevant to the EIRA, the management contract between BBIM and BBI does not give B&B the ability to direct the actions of BBI, BBI NZ or Powerco.
- 41 For these reasons, B&B is not "involved" in BBI by virtue of the management contract between BBIM and BBI.

Common managers

- 42 Phillip Green is director on the boards of both B&B and BBI. Peter Hofbauer is a director of BBI and a senior manager of B&B. A director or senior manager is a "manager" for EIRA purposes (section 3), which are deemed under the EIRA to have material influence over an electricity business (section 11). This means that Phillip Green and Peter Hofbauer are involved in both electricity businesses.

BBIM

- 43 As noted above, BBIM is "involved" in BBI because it has material influence over BBI by performing the management contract between BBIM and BBI (section 11(1)(a) of the EIRA). The managers employed by BBIM to deliver management services to BBI also have material influence over BBI by being persons in accordance with whose directions BBI may be required to act (section 11(1)(c)).
- 44 However, neither BBIM nor the individual BBI managers employed by BBIM are "involved" in B&B because they do not;

- 44.1 carry on the B&B business (B&B is the parent of BBIM);
- 44.2 exceed the 10% threshold in respect of that business; or
- 44.3 have material influence over the business.

Exemption sought

- 45 Section 81 of the EIRA states that the Commission may exempt any business, involvement or interest from the application of the EIRA, or any person or class of persons from compliance with any provisions of the EIRA.
- 46 If B&B was a supply business by virtue only of its involvement in Te Rere Hau wind farm, then B&B could rely on section 46A of the EIRA. Section 46A provides an exception from the cross ownership prohibition for "new generation" from "new renewable energy sources", provided that sections 24 and 25 of the EIRA are complied with.
- 47 "New generation" is defined as generation not existing on 8 August 2001. Wind fits within the definition of "new renewable energy source", as it occurs naturally and its use will not permanently deplete New Zealand's energy sources of that kind.
- 48 B&B can therefore rely on the section 46A exemption in respect of Te Rere Hau wind farm, as long as B&B complies with sections 24 and 25 of the EIRA.
- 49 B&B complies with section 24, as its electricity lines business interests (BBI) are separate from its electricity supply business interests (NPBB).
- 50 However, B&B does not fully comply with the Arms Length Rules. Rules 7-10 require the management of electricity lines and electricity supply businesses to be separate. As discussed above, a director of B&B, Phillip Green, and a senior manager of B&B, Peter Hofbauer, are also directors of BBI.
- 51 B&B would like these managers to retain their directorships in BBI. Both are skilled and valued directors of BBI. There is a limited pool of directors who are experienced at managing large scale infrastructure investments of the type that B&B and BBI own.
- 52 The interest in Glenbrook must also be considered. Due to B&B's involvement in Glenbrook, B&B will have involvements in supply businesses that extend beyond the scope of the section 46A exception. This brings the general prohibition in section 17 on cross involvement into play.

- 53 B&B therefore seeks an exemption from section 17 of the EIRA for its involvement in BBI. A condition of this exemption could be compliance with the corporate separation and arms length rules (the outcome required by section 46A). However, as stated above, B&B seeks an exemption from Arms Length Rules 7-10.

Cross-involved director

- 54 As discussed above, Phillip Green and Peter Hofbauer are deemed to be involved in both B&B and BBI, and are therefore cross involved.
- 55 If the Commission were to grant an exemption to B&B, any such cross involvements could be disregarded through the operation of section 19(1)(h):

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...

- 56 Consequently, B&B seeks an exemption from rules 7 – 10 of the Arms Length Rules so that it and these managers may continue their involvement in BBI.

Analysis in relation to the Commerce Commission's three primary criteria

- 57 The Commission's exemption application guidelines state that the Commission will consider three primary questions in considering applications for exemption under section 81 of the EIRA. Analysis in relation to each of these questions is set out below.

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?

- 58 B&B considers that there would be no practical opportunities or incentives to inhibit competition.

- 59 B&B's direct interest in BBI is only 8.2%.

- 60 It is important to recall that BBI has a wide portfolio of investments, of which Powerco is only one. BBI is listed on the ASX and is widely held, and directors and management of BBI must make decisions in the best interests of BBI, not B&B.

- 61 As noted by the Commission in Decision No. 618, the Te Rere Hau wind farm will form a very small part of the wholesale market.
- 62 The exemption sought by B&B is on the condition of complying with the Arms length Rules, apart from the requirements in Arms Length Rules 7-10 for separate management. The requirement in the Arms length Rules for independent decision making will still apply.
- 63 As previously noted, the BBIM management contract does not give B&B the ability to direct or influence the actions of BBI. B&B is even further removed from the operation of Powerco.
- 64 Two directors with an involvement in B&B will not affect the independence of decision-making at BBI. The BBI board has a majority of independent directors. Any BBI director who has a material interest in a B&B matter (which would include Phillip Green and Peter Hofbauer) must under Australian company law declare that interest and is excluded from the Board meeting while the matter is discussed and voted on. Decisions on that matter are then made solely by the independent directors, having regard only to the interests of BBI. While the Board has the ability to permit an interested director to be present for the discussion, in practice, when matters involving B&B are discussed at BBI board meetings Phillip Green and Peter Hofbauer take no part in the discussion of those matters. This is best practice - a common director will continue to have fiduciary duties to both companies.
- 65 For these reasons, it is highly unlikely that the minor involvement of B&B in BBI, or the position of these two directors, will result in less independent decision making at BBI.
- 66 Further, B&B's generation activities are pro-competitive. The development of Te Rere Hau is pro-competitive for the electricity generation market. It shows the increasing viability of wind as a source of generation, and the willingness of investors (especially international investors) to enter the New Zealand arena.
- 67 Glenbrook is embedded in New Zealand Steel. It is technically connected to the grid, but its only customer is New Zealand Steel. Glenbrook does not export electricity to the grid, and it is not possible to operate the power plant without the steel works. The power plant does not provide the steel works' full electricity requirements and so is irrelevant in terms of 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?

- 68 As noted above, the aggregated interests of B&B and its associates' interests in BBI are limited to just over 10%. The fact that the remaining 90% of BBI is held by other parties means that it is highly unlikely for there to be incentives or opportunities for B&B's generation activities to be cross subsidised from Powerco's operations as an electricity lines business.
- 69 It is relevant in this context that Powerco provides lines services to the Te Rere Hau wind farm. The existing turbines are currently connected by 11kV lines to Powerco's local network. However, this is a temporary solution. It is proposed that the turbines will be connected to the national grid via a Trustpower substation. Powerco will build a transmission network for this purpose and will eventually, over the course of the next 12 months, operate the transmission lines connecting the 97 turbines to the substation. These transmission lines will be separate from Powerco's distribution network, and no turbines will remain connected to Powerco's distribution network.
- 70 Again, it is highly unlikely that B&B's small shareholding in BBI will result in this stand alone transmission investment by Powerco cross subsidising the Te Rere Hau wind farm.
- 71 From a purely commercial perspective, the fact that B&B has only a 25% involvement in the Te Rere Hau wind farm also means any attempt to cross subsidise is unlikely. B&B would only pick up a quarter of any transfer of value to the wind farm.
- 72 From a wider perspective, B&B considers that the regulatory environment that has developed since the introduction of the EIRA needs to be borne in mind when assessing whether cross involvement could create opportunities for cross-subsidisation or to inhibit competition.
- 73 Part 4A of the Commerce Act introduced thresholds for the investigation of electricity lines businesses and a price control regime. This provides an assurance that electricity lines businesses are not earning monopoly rents that could be used to cross subsidise competitive activity.

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 electricity supply business which is not at arms length?

- 74 B&B's position of being involved in both electricity lines and electricity supply businesses is a step removed from *being* an electricity supply business that is cross involved with an electricity lines business.

- 75 In Decision 541, the Commission acknowledged that compliance with the arms length rules is not always strictly necessary, stating at paragraph 76:

In most circumstances where an exemption is required from the ownership separation rules a relationship will be created that will ultimately not be at arms' length.

- 76 The Commission then stated that its approach in such cases is to assess 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 EIRA.
- 77 Following this approach, B&B considers that an exemption being granted from Arms Length Rules 7-10 will not compromise the purpose of the EIRA. The minor cross involvement of B&B does not provide any incentives or opportunities for inhibition of competition or cross subsidisation, for the reasons stated above.
- 78 Further, as mentioned above, it is common practice for any BBI director who is interested in a B&B matter to be precluded from voting on decisions in relation to that matter. This practice provides an extra level of comfort as to the arms length nature of the B&B/BBI relationship.
- 79 The exemption sought in respect of Glenbrook will have no effect on the arms' length relationship between B&B and BBI.
- 80 In short, B&B's cross involvement does not interfere with the overall purpose of the EIRA to ensure that costs and prices are subject to sustained downward pressure, and that the benefits of efficient electricity pricing flow through to all classes of consumers.

Electricity Industry Reform Amendment Bill 2007

- 81 B&B submits that this is a situation in which an exemption is appropriate under the current legislation because it does not give rise to the policy issues that the EIRA is concerned with.
- 82 This position is confirmed by the Government's proposed EIRA reforms. The reforms would not change the underlying policy of the EIRA. They would simply focus the EIRA in on the current areas of concern, which would not capture the minor cross involvement that B&B has outlined above.

Further information

- 83 Please contact either Chapman Tripp or B&B if any further information is required in relation to this application.

DECLARATION

THIS APPLICATION is made by **Babcock & Brown International Pty Ltd**

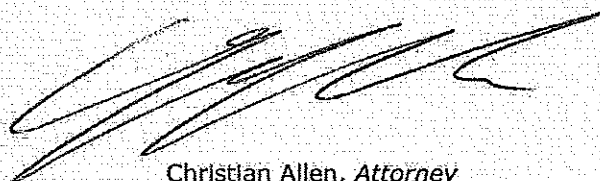
The company hereby confirms that:

- all information requested by the Commerce Commission has been supplied;
- all information known to the applicants which is relevant to the consideration of this application has been supplied to the Commerce Commission; and
- all information supplied by the applicants to the Commerce Commission is correct as at the date of this application.

The company undertakes to advise the Commerce Commission immediately of any material change in circumstances relating to the application.

Date: 3 October 2007

Signed by:



Christian Allen, *Attorney*

I am an Officer of the company and am duly authorised to make this application.