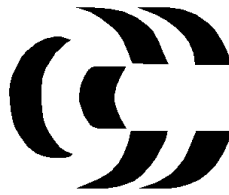


# Public Version



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## COMMERCE COMMISSION

### Decision No. 353

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:

#### **TOP ENERGY LTD**

**The Commission:**

K M Brown  
E C A Harrison  
P R Rebstock

**Commission Staff:**

D R Ainsworth

**Summary of  
Application:**

Top Energy Ltd, 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 (Part A of the application) and to extend the time available to it under the EIR Act to retain the option of establishing a mirror trust (Part B of the application). This Decision addresses Part A of the application. In Decision 349, the Commission granted Top Energy Ltd's part B application to extend the time available to it to establish a mirror trust for 90 calendar days from the date of this Decision 353.

**Determination:**

The Commission, pursuant to section 81 of the EIR Act, in respect of Part A of Top Energy Ltd's application for exemption, declines to exempt Top Energy Ltd from the application of the EIR Act in relation to a prohibited cross-involvement in an electricity supply and an electricity lines business.

**Date of Determination:**

10 June 1999

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## INTRODUCTION

- 1 On 11 March 1999, the Commerce Commission (the Commission) received an application from Top Energy Ltd (Top Energy) for exemption from the application of the EIR Act. The application was in two parts:
  - Part A, in which Top Energy sought an exemption from the requirement to separate the ownership of its electricity lines and electricity supply businesses as required by section 17 of the EIR Act. Ownership separation requires the transfer of Top Energy's shares in the Ngawha Power Station (Ngawha)<sup>1</sup> either to another person or to a mirror trust. This Decision considers Part A of Top Energy's application.
  - Part B, in which Top Energy sought an exemption from the requirement of sections 38 and 39 of the EIR Act, to transfer the assets of Ngawha to a mirror trust *by 1 April 1999*<sup>2</sup>.
- 2 On 26 March 1999 the Commission, in Decision 349, granted Top Energy exemption from the application of sections 38(1)(c) and 39 of the EIR Act for a period of 90 days subsequent to the date of the Commission's decision in respect of Part A of Top Energy's application. As a result, Top Energy has retained the option to form a mirror trust and transfer the assets of Ngawha to that mirror trust if the Commission declines Part A of its application for exemption.
- 3 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.

## TOP ENERGY LTD

- 4 Top Energy is wholly owned by the Bay of Islands Electric Power Trust, an electricity consumer trust.
- 5 Top Energy owns the electricity distribution network which services the northern part of the Northland peninsular including Kaitaia, Kaikohe and Kerikeri. Top Energy supplies line function services to about 24,500 customers who consume approximately 280 gigawatt-hours<sup>3</sup> of electricity per annum.
- 6 Top Energy also owns part of Ngawha, located close to Kaikohe. Ngawha consists of two geothermal steam powered electricity generating units each with a nameplate capacity of 5,800 kilowatts (ie a total nameplate capacity of 11.6 megawatts). Construction was commenced on the power station site in November 1997. The equipment was delivered to the site in January 1998 and the machines first ran in June

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<sup>1</sup> In particular, its shares in Top Generation Ltd (see Appendix 1).

<sup>2</sup> The ability to transfer assets to a mirror trust is an exemption in some respects from the ownership separation rules of the EIR Act. An electricity trust which has a prohibited cross-involvement in an electricity supply and an electricity lines business may establish a mirror trust to hold part of its assets, the ownership of which by the electricity trust results in the prohibited cross-involvement. The qualifying conditions in respect of the mirror trust option are enacted in section 38 of the EIR Act. One of these conditions is that a mirror trust is established by 1 April 1999.

<sup>3</sup> Less than 2% of electricity distributed in the national electricity retail market.

1998. The power station was regarded as fully commissioned on 1 September 1998. It is expected to generate approximately 70 gigawatt-hours of electricity per annum. The cost of the plant was about \$26 million.

- 7 Top Energy holds its interest in Ngawha through several subsidiaries. The Tai Tokerau Maori Trust Board (Tai Tokerau) also owns part of Ngawha, holding its interest through Tai Tokerau Ngawha Ltd. These relationships are shown in Appendix 1. [

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- 8 [

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- 9 On 14 December 1998, Top Energy sold its retail customer contracts to Contact Energy Ltd (Contact). The Ngawha assets were not included in the sale. In addition, Top Energy entered into an agreement with Contact for the purchase of electricity generated at Ngawha. This agreement requires Contact to take all electricity generated by Ngawha for a period of three years. Top Energy has the option to renew the agreement for a further two years. Contact is required to pay [

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- 10 Top Energy has an arrangement with a sole trader, Mr Peter Dorrington, in respect of the operation and management of Ngawha. Mr Dorrington is responsible for the part time operation and routine maintenance of the power station and reports directly to the Chief Executive of Top Energy.

## **INVOLVEMENTS**

### **Electricity Lines Business**

- 11 Top Energy is the owner of an electricity distribution network. 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).
- 12 Therefore Top Energy is an electricity lines business in terms of the EIR Act. Top Energy agrees with this interpretation.
- 13 Top Energy:

- carries on an electricity lines business alone (s7(1)(a));
- exceeds the 10% threshold in terms of control and equity return rights in that business (s7(1)(b)); and
- has material influence over that business (s7(1)(c)).

14 Therefore, Top Energy is involved in an electricity lines business in terms of the EIR Act.

### **Electricity Supply Business**

15 Top Energy in terms of the EIR Act:

- sells electricity in New Zealand (s5(1)(a)(i));
- generates electricity in New Zealand (s5(1)(a)(iii));
- owns and operates directly a generator in New Zealand (s5(1)(b); and
- has no other activities excluded from the definition of an electricity supply business by section 5(2).

16 Therefore, Top Energy is an electricity supply business in terms of the EIR Act. Top Energy agrees with this interpretation.

17 Top Energy:

- carries on an electricity supply business alone or together with associates (s7(1)(a));
- exceeds the 10% threshold in terms of control rights or equity return rights in that business (s7(1)(b)); and
- has material influence over that business (s7(1)(c)).

18 Therefore, Top Energy is also involved in an electricity supply business in terms of the EIR Act.

### **PROHIBITED CROSS-INVOLVEMENT**

19 Section 17 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.”

20 Top Energy is involved, and wishes to remain involved, in both an electricity lines and an electricity supply business. In that case, Top Energy will have a prohibited cross-involvement in terms of section 17 of the EIR Act.

- 21 Top Energy 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**

- 22 For the purpose of considering this application, 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, and P R Rebstock.
- 23 The Commission's decision is based on an investigation conducted by its staff and their subsequent advice to the Commission.
- 24 During their investigation Commission staff inspected Ngawha and interviewed Top Energy's management and its lawyers.

### **Criteria Used by the Commission to Consider Exemption Applications**

- 25 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.<sup>4</sup>
- 26 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 EIR 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 EIR Act. That 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.”

- 27 The Commission noted in Practice Note No.3 that:
- “the EIR Act provides for maximum cross-ownership limits and specific structural and

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<sup>4</sup> Practice Note No.3, September 1998, Electricity Industry Reform Act 1998 Commission's Role and Processes.

behavioural requirements to ensure that the purposes of the EIR Act are met. Strict compliance with these limits and requirements is, other than in exceptional circumstances,<sup>5</sup> expected.”

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

“On receipt of an application 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 EIR 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?; and
- 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 markets 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.”

## RELEVANT MARKET

29 The national electricity generation market is relevant to the application of the Commission’s criteria to the facts of Top Energy’s Part B application for exemption.<sup>6</sup>

## TOP ENERGY’S ARGUMENTS

30 Top Energy does not wish to sell its interest in Ngawha, which it regards as a cornerstone asset of the local community. It maintains that a sale caused by the ownership separation provisions of the EIR Act, at a time of excess national electricity generation capacity and depressed electricity prices and before the plant’s operational performance is proven would be detrimental to its interests. The existing generating station is a pilot plant which requires future expansion in size to realise available economies of scale to make the plant truly viable. Further, it is Top Energy’s view that the involvement of Tai Tokerau in the scheme was an essential requirement to ensure the granting of Resource Management Act consents, given Tai Tokerau’s existing use of the Ngawha geothermal resource. The concept of a sale outside Northland would not therefore be acceptable to Top Energy’s Board of Directors. As a result, Top Energy intends to either retain its interest in the Ngawha assets, if it can obtain Commission exemption, or, if not, transfer the assets to a mirror trust. In Top Energy’s view, the former option is the better of the two because the latter will result in the unnecessary duplication of overheads in Top Energy and in the mirror trust.

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<sup>5</sup> For example, of the types provided for in section 19 of the EIR Act.

<sup>6</sup> Other markets in the electricity industry, for example the wholesale electricity market, the electrical construction and maintenance market, the market for the reticulation of new subdivisions, the local distribution market, and the national electricity retail market, do not appear to be relevant to this application for exemption.

- 31 The plant has two electricity generating units. Each has a nameplate showing a gross capacity of 5,800 kilowatts. However, the plant itself consumes about two megawatts of its output as auxiliary power. Further, it operates at above optimum ambient air temperatures and is subject to a steam flow restriction due to the requirements of its Resource Management Act consents. These factors result in a net maximum output of between eight and nine megawatts.
- 32 Commission staff met with Top Energy's management and legal adviser twice. In those meetings Top Energy argued that the powers of exemption granted to the Commission in the EIR Act were broad and it was necessary for the Commission to properly consider every application for exemption. Top Energy argued Parliament intended that while the cross-ownership of an electricity lines business and an electricity generator of five megawatts or less, *by definition*, does not interfere with the purposes of the EIR Act, it was necessary for an applicant for exemption *to prove* to the Commission that its cross-ownership of an electricity lines business and an electricity generator larger than five megawatts does not interfere with the purposes of the EIR Act. Top Energy further argued that the closer the power station's capacity was to 5 megawatts the easier it would be for the applicant to prove to the Commission that its cross-ownership did not interfere with the purposes of the Act.
- 33 Top Energy noted at the meetings that the current Electricity (Information Disclosure) Regulations do not require disclosure of any information by an electricity lines company in respect of electricity generation of less than 10 megawatts in total. Top Energy argued that the inference in this related competition statute, that ownership of an electricity lines business and electricity generation of less than 10 megawatts was insignificant, could be imported into the Commissions' consideration of Top Energy's application for exemption under the EIR Act.
- 34 Top Energy stated at the meetings that if the Commission declined Top Energy's application for exemption it was not its intention to sell the Ngawha scheme. Rather it would place the assets in a mirror trust. When it did that, Top Energy intended to transfer part of the debt on the project to the new mirror trust and retain the remainder of the debt with Top Energy's lines business to be repaid, in effect, by the users of Top Energy's electricity distribution network. The amount of debt to be transferred to the mirror trust would be an amount which enabled the project to be financially viable. Top Energy argued that because of this plan, a cross-subsidy from its electricity lines business to the Ngawha generator would occur, whether or not the Commission decided to exempt Top Energy from the application of the Act.
- 35 Top Energy stated at the meetings that any initial problems resulting from geothermal steam contaminants had been solved and that the average availability of the plant had been 75% in the first six months of operation. Further, the Resource Management Act risks<sup>7</sup> and the risk of electricity price changes did not apply until 2004, the latter as a result of the electricity purchase contract with Contact. Top Energy suggested that the Commission might decide to make any exemption it granted expire in 2004 before these risks were realised.

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<sup>7</sup> That is the risk of the current Resource Management Act consents not being renewed when they expire in 2004 and, given Top Energy's desire to increase the size of the plant at that time, the risk that the current consents will not be expanded to allow such an increase in size to take place.

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- 37 Top Energy suggested that, while any exemption the Commission granted would result in a relationship between an electricity lines and supply business not at arms length, which is contrary to the purposes the EIR act, the EIR Act was aimed at significant generation stations owned and operated by electricity lines businesses where the lines business retained control of the output volume and price of the electricity generated. It argued that the situation covered by the application was distinguishable because of the small size of the station and the fact that the output and price were fixed by the long term contract with Contact.
- 38 Finally Top Energy suggested that any exemption given by the Commission would not open the floodgates of applications for exemption because Ngawha was the last remaining electricity generator larger than five megawatts owned by an electricity lines business.

## **EXAMINATION IN TERMS OF THE COMMISSION'S CRITERIA**

### **Incentives Or Opportunities To Inhibit Competition in the Electricity Industry**

- 39 The Commission has examined the incentives or opportunities (which would result from the granting of the exemption requested) for Top Energy to inhibit competition in the national electricity generation market. The potential output of Ngawha is negligible in terms of the size of this market<sup>8</sup>. As a result of the split of ECNZ Ltd into competing generators together with the existence of other major generators, this market is competitive in nature. Therefore, the Commission does not consider the granting of an exemption would result in incentives or opportunities to inhibit competition in electricity markets.

### **Incentives or Opportunities to Cross-subsidise Generation Activities**

- 40 The Commission considers that incentives or opportunities to cross-subsidise generation activities from electricity lines business are present whenever cross-involvements exist. If an exemption was granted, incentives or opportunities would be created to cross-subsidise the generation activities at Ngawha from Top Energy's electricity lines business by, for example:
- the allocation of current overhead, debt and capital costs of Ngawha to Top Energy's electricity lines business;
  - the allocation of depreciation and tax benefits of Top Energy's electricity lines business to Ngawha;
  - the connection of Ngawha to its electricity distribution network at less than normal commercially negotiated terms; and

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<sup>8</sup> With an output of 70 gigawatt-hours per annum, Ngawha would provide 0.2% of annual electricity generation in New Zealand.

- further capital injection by Top Energy's electricity line business if one of the risks faced by Ngawha crystallises.

- 41 *Opportunities* to cross-subsidise would arise in the circumstances of an exemption as Top Energy's board of directors and management would be wholly in control of both Ngawha and Top Energy's lines business. *Incentives* to cross-subsidise following an exemption would arise as a result of the need to prop up the economics of the Ngawha scheme. The Commission considers that the spread sheet provided by Top Energy is overly optimistic [
- ]
- 42 The Commission does not believe that the project risks can be discounted as easily as Top Energy believes. The potential for non-renewal and non-expansion of the Resource Management Act consents in 2004 may arise if there is any serious diminution of the Ngawha geothermal steam field's output which affects other steam field users. This has occurred at other steam fields in New Zealand which supply geothermal power stations.
- 43 The Commission also believes Ngawha will face an electricity price risk when its contract with Contact expires. Competition in electricity generation markets is now very real as a result of the split of ECNZ and the establishment of the Wholesale Electricity Market.
- 44 The Commission notes Top Energy's argument that, given its intention to place the Ngawha assets in a mirror trust but to retain part of the debt of the project in Top Energy's electricity lines business, a cross subsidy will occur with or without a Commission exemption. The Commission considers that this situation is no different to that of the sales of many electricity supply businesses when the power company concerned owned an electricity price hedge contract with ECNZ. In most such situations the hedge contracts had a negative value due to declining wholesale electricity market prices and the electricity lines companies were forced to take a loss when their electricity supply businesses were sold. In such situations arguments of the kind advanced by Top Energy were not advanced by the power companies attempting to prevent ownership separation.
- 45 Ngawha is the only remaining power station owned by an electricity lines business. The Commission notes that all other electricity lines companies, including those with trust shareholders, complied with the legislation that electricity lines businesses shall not, other than in exceptional circumstances, own or operate electricity generators larger than five megawatts.

### **A Relationship Not at Arms Length**

- 46 If granted an exemption by the Commission, Top Energy proposes to continue to own and operate both an electricity lines business and an electricity supply business. The two businesses will have common directors, managers, premises and records. Top Energy's Board of Directors and its Managers will make decisions crucial to the operation both types of business, for example:

- line pricing and the price at which the output of Ngawaha is sold to the incumbent retailer trading over Top Energy's electricity distribution network;
- the allocation of electrical losses to the electricity lines or the supply business; and
- the allocation of debt and overheads between Top Energy's electricity lines business and Ngawaha.

Managers are likely to act in the interests of one business in a non-neutral manner over that of the other. Information which is confidential to one business will be available to the other business. The relationship between Top Energy's electricity lines and supply businesses will not be at arms length.

- 47 The Commission has noted Top Energy's suggestion that section 2(2)(b) is aimed only at significant electricity generators owned and operated by electricity lines businesses where the lines business retained control of the price and quantity of electricity generated. The Commission does not accept this argument. In its view, the subsection is aimed at all electricity generators, large and small, whether or not contractually constrained in respect of electricity output and sale price.
- 48 Top Energy has argued that the net output of Ngawaha should be used by the Commission in determining such matters as whether or not the two types of business are at arms length. Top Energy states that the closer a generator is to the five megawatts exclusion from the definition of an electricity lines business found in section 5(3) of the EIR Act, the easier it will be for the Commission to find, for example, a non arms length relationship. Top Energy argue that Ngawaha has a net output of between eight and nine megawatts which is only marginally above the section 5(3) figure. The Commission does not consider that interpretation is correct. Section 5(3) is quite specific in its reference to the generator's capacity being determined according to its nameplate. As a consequence, in considering the issues raised by Top Energy's application such as the existence of a non arms length relationship, the Commission has viewed the capacity of Ngawaha to be its nameplate capacity, 11.8 megawatts.

**THE COMMISSION'S DECISION**

- 49 Top Energy's Part A application passes one but fails two of the criteria<sup>9</sup> used by the Commission to decide upon exemptions from the EIR Act. Therefore, the Commission, pursuant to section 81 of the EIR Act, declines to grant an exemption from the application of section 17 of the EIR Act.
- 50 In terms of the exemption granted by the Commission in respect of Part B of Top Energy's application for exemption, Top Energy has 90 days from the date of this decision to comply with the requirements of section 17 of the EIR Act and carry out ownership separation of its electricity lines and supply businesses.

Dated this      day of June 1999

The Commission

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<sup>9</sup> While the Commission does not consider the granting of an exemption to Top Energy would inhibit competition in electricity markets, it does consider the granting of an exemption would result in the creation of incentives or opportunities for Top Energy to cross-subsidise generation activities and a relationship between an electricity lines business and an electricity supply business which is not at arms length.