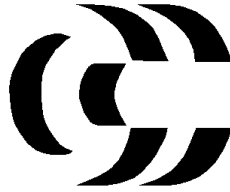


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## COMMERCE COMMISSION

### Decision No. 354

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:

#### **BHP NEW ZEALAND STEEL LTD**

**The Commission:**

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

**Commission Staff:**

D R Ainsworth  
A J Brice

**Summary of  
Application:**

BHP New Zealand Steel 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 in order to remain involved in both kinds of business.

**Determination:**

The Commission, pursuant to section 81 of the EIR Act, exempts BHP New Zealand Steel Ltd 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:**

13 May 1999

**Date of Exemption:**

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

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## CONTENTS

<b>INTRODUCTION .....</b>	<b>3</b>
<b>BHP NEW ZEALAND LTD.....</b>	<b>3</b>
BHP'S ELECTRICITY LINES BUSINESS .....	3
BHP'S ELECTRICITY SUPPLY BUSINESS .....	4
<b>INVOLVEMENTS .....</b>	<b>5</b>
ELECTRICITY LINES BUSINESS.....	5
ELECTRICITY SUPPLY BUSINESS.....	5
<b>PROHIBITED CROSS-INVOLVEMENT.....</b>	<b>6</b>
<b>COMMISSION PROCEDURES.....</b>	<b>6</b>
GENERAL.....	6
CRITERIA USED BY THE COMMISSION TO CONSIDER EXEMPTION APPLICATIONS .....	6
<b>RELEVANT MARKET .....</b>	<b>7</b>
<b>BHP'S ARGUMENTS IN FAVOUR OF PERMANENT EXEMPTION.....</b>	<b>8</b>
<b>EXAMINATION OF PART B OF BHP'S APPLICATION IN TERMS OF THE COMMISSION'S CRITERIA .....</b>	<b>8</b>
INCENTIVES OR OPPORTUNITIES TO INHIBIT COMPETITION IN THE ELECTRICITY INDUSTRY .....	8
INCENTIVES OR OPPORTUNITIES TO CROSS-SUBSIDISE GENERATION ACTIVITIES.....	9
A RELATIONSHIP NOT AT ARMS LENGTH .....	10
<b>THE COMMISSION'S DECISION.....</b>	<b>10</b>
<b>NOTICE OF EXEMPTION .....</b>	<b>11</b>

## **INTRODUCTION**

- 1 The Commerce Commission (the Commission) has received an application from BHP New Zealand Steel Ltd (BHP) for exemption from the application of the EIR Act. The first application was received on 22 March 1999. An amended application was received on 31 March 1999.
- 2 BHP's application is in two parts. Part B is an application for permanent exemption from the ownership separation provisions of the EIR Act. Part A is an application for exemption from the ownership separation provisions for 28 days from 1 April 1999. This is to allow BHP to implement ownership separation of its electricity lines and supply businesses should part B of its application for permanent exemption be unsuccessful.
- 3 BHP further amended its application on 28 April 1999 by facsimile transmission. It stated that its part A application was for a temporary exemption, from the application of the EIR Act, for 28 calendar days from the date of any refusal by the Commission, to permanently exempt under part B of its application.
- 4 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.

## **BHP NEW ZEALAND LTD**

- 5 BHP is a producer of iron and steel from the naturally occurring iron sands found on the west coast of the North Island. Its production plant is located at Glenbrook on the south coast of the Manukau Harbour and its iron sand mines at the north head of the Waikato River mouth and at Taharoa, south of the Kawhia Harbour.
- 6 BHP also has a wholly owned subsidiary, Steltech Ltd, in South Auckland and a 50% share in Slag Reduction New Zealand Ltd, situated at Glenbrook. The former company is a steel fabricator and the latter disposes of the waste products resulting from iron and steel manufacture.

## **BHP's Electricity Lines Business**

- 7 BHP owns and operates a number of electricity distribution networks (networks) at the sites described above. Glenbrook<sup>1</sup>, and the two iron sand mines are reticulated with 11,000/400 volt networks and the other site with a 400 volt network.
- 8 In the case of the Glenbrook site, BHP takes its electricity supply directly from Transpower's Glenbrook substation and from the on-site electricity generators and distributes it throughout the facility. In the case of the other sites, BHP takes its electricity supply from local electricity companies and distributes it throughout those sites. BHP conveys approximately [ ] GWh per annum over its various networks, including [ ] GWh per annum to BOC Gases NZ Ltd (BOC) and [ ] GWh per annum to

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<sup>1</sup> Including Slag Reduction NZ Ltd.

Duke Energy NZ Ltd<sup>2</sup> (Duke). BOC produces nitrogen and oxygen on the Glenbrook site and Duke is the on-site electricity generator.

- 9 BHP charges Duke for a contribution to the maintenance costs of BHP's high voltage electricity network. This charge is nominal at 0.1 cents per kilowatt-hour. Other than this, it does not charge BOC or Duke for the use of its network.

### **BHP's Electricity Supply Business**

- 10 BHP purchases its electricity:
- for its Glenbrook site from Duke, Electricity Corporation of New Zealand (The Residual Company) Ltd (ECNZ) and the spot market. Slightly less than half of the electricity consumed at the Glenbrook site is generated on the site by Duke. BHP has arranged electricity price hedge contracts with ECNZ for about [ ] of its remaining electricity supply requirements and the balance of its electricity consumption is purchased at spot prices from the wholesale electricity market.;
  - for its Waikato River north head site from Genesis Power Ltd;
  - for its Taharoa site from King Country Energy Ltd; and
  - for its South Auckland site from First Electric Ltd.
- 11 BHP supplies electricity to two companies, which operate on the Glenbrook site and which are suppliers of goods and services to BHP.
- 12 BHP supplies approximately [ ] GWh per annum of electricity to BOC. BOC is located at Glenbrook and provides oxygen and nitrogen gases to BHP for use in the iron and steel making processes. Electricity is a large component of BOC's costs and is used to drive large air compressors. BHP charges BOC [ ] together with a share of BHP's actual charges for electricity transmission from Transpower Ltd<sup>3</sup>. The price which BOC charges BHP for the gases it supplies is directly related to the price BOC is charged for electricity by BHP.
- 13 Duke has recently purchased the, formerly BHP owned, electricity generation equipment on the Glenbrook site. Duke utilises waste heat from the iron and steel making processes to generate electricity from three turbo-alternators whose total capacity is 110 megawatts. Duke has a take-or-pay contract with BHP to supply it with up to [ ] GWh of electricity per annum. However, due to the historical arrangement of the electrical reticulation on the Glenbrook site BHP, rather than Duke, supplies electricity to the electric motors driving the auxiliary equipment associated with Duke's turbo-alternators. For this reason, BHP supplies approximately [ ] GWh per annum of electricity to Duke. BHP charges Duke on the basis of BHP's total average electricity purchase cost, without the addition of a margin, together with a contribution to BHP's high voltage network maintenance costs.
- 14 BHP does not own or operate an electricity generator.

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<sup>2</sup> The wholly owned subsidiary of Duke Energy Inc, a North Carolina based electricity and natural gas utility company.

<sup>3</sup> The share is determined by the ratio of BOC's electricity consumption to that of BHP's.

## INVOLVEMENTS

### Electricity Lines Business

- 15 BHP 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).
- 16 BHP:
- 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)).
- 17 Therefore BHP is involved in an electricity lines business in terms of the EIR Act. BHP agrees with this interpretation.

### Electricity Supply Business

- 18 BHP in terms of the EIR Act:
- sells electricity in New Zealand (s5(1)(a)(i));
  - owns and operates directly core assets of an electricity retail business which include the benefit of contracts to sell electricity (s5(1)(c));
  - has no other activities excluded from the definition of an electricity supply business by section 5(2);
- 19 BHP:
- carries on an electricity supply 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)).
- 20 Therefore, BHP is also involved in an electricity supply business in terms of the EIR Act. BHP agrees with this interpretation.

## **PROHIBITED CROSS-INVOLVEMENT**

- 21 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.”
- 22 BHP is involved, and wishes to remain involved, in both an electricity lines and an electricity supply business. BHP has, in terms of section 17 of the EIR Act, a prohibited cross-involvement.
- 23 BHP 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**

- 24 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.
- 25 The Commission’s decision is based on an investigation conducted by its staff and their subsequent advice to the Commission.
- 26 During their investigation into this application for exemption, Commission staff interviewed and obtained information from:
- BHP; and
  - Duke.

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

- 27 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>
- 28 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:

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

- (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.”

29 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,<sup>(5)</sup> expected.”

30 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)<sup>6</sup> 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

31 The national electricity retail market is relevant to the application of the Commission’s criteria to the facts of BHP’s application for exemption.<sup>7</sup>

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

<sup>6</sup> Defined using the same process as used for market definitions in respect of Commerce Act matters.

<sup>7</sup> 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.

## **BHP'S ARGUMENTS IN FAVOUR OF PERMANENT EXEMPTION**

- 32 BHP argues that its main business is the production of iron and steel products and that its electricity sales to Duke and BOC are only a “very small” fraction [ ] of its total income. Moreover, its sales to Duke and BOC are only a small part of the national retail electricity market and are unlikely to affect the level of competition in that market.
- 33 BHP does not charge Duke and BOC for the use of its network, nor does it charge a margin over its electricity purchase costs. It does use a different methodology to calculate the price of the electricity it supplies to the two companies. Duke pays BHP's overall average purchase cost of electricity at the Glenbrook site (ie: total cost divided by total consumption) and adds a small contribution to BHP's network maintenance costs. BOC's electricity price is established by [ ] plus transmission charges. The two prices will differ [ ]
- 34 BHP's agreement with BOC in respect of the price it pays for oxygen and nitrogen produced at BOC's Glenbrook plant allows the price of the gases to rise in proportion to [ ] of any electricity price rise. Therefore BHP argues that that this removes any incentive for it to overcharge BOC for electricity or to act anti-competitively.
- 35 The price of electricity supplied by BHP to Duke for the operation of Duke's auxiliary equipment is specified in the electricity supply contract Duke has with BHP. BHP argues that Duke<sup>8</sup> is able to, and has, tested the national retail electricity market in an attempt to source cheaper electricity than that available from BHP to power its auxiliaries. If Duke decides to use any cheaper source of electricity available to it, the consequential savings in costs are able to be retained by Duke. Therefore BHP argues there is no incentive or ability for it to overcharge Duke.

## **EXAMINATION OF PART B OF BHP'S APPLICATION IN TERMS OF THE COMMISSION'S CRITERIA**

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

<p>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?</p>
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- 36 The focus of the following analysis is on that part of the national electricity retail market comprising BOC and Duke and whether an exemption would provide BHP with incentives or opportunities to inhibit competitive electricity supply to them.
- 37 The Commission notes BHP's arguments that electricity supply revenue is a “very small” proportion of its total revenue and that the combined consumption of BOC and Duke is a very small part of the national retail electricity market. However, the EIR Act defines the activities of an electricity lines business and an electricity supply

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<sup>8</sup> And also BOC.

business. Where activities fall within these definitions,<sup>9</sup> the EIR Act will apply regardless of whether the electricity supply is a major or minor part of either a firm's operations or of the national electricity retail market.

- 38 The Commission considers that BHP has incentives to provide electricity at low prices to BOC, whether it be supplied by itself or a competing electricity retailer, as electricity pricing affects BHP's own costs. These incentives would not be changed by the granting of an exemption. Any increase in electricity price charged to BOC would be passed back to BHP.
- 39 In terms of BHP's electricity supply to Duke, at the beginning of each contract year BHP notifies Duke of the charge it intends to make for electricity supply to Duke's auxiliary equipment. The price which BHP in turn pays Duke for the electricity it generates and supplies to BHP is not related to that charge. In this situation the Commission considers BHP does not have the incentive to provide electricity supply to Duke at the lowest possible cost.
- 40 However, the Commission considers that BHP does not have the opportunity to inhibit competitive electricity supply to Duke. BHP only charges Duke a nominal maintenance contribution. Therefore, BHP has no opportunity to alter the balance of its pricing between supply of distribution services and supply of electricity. It is not possible for BHP to use its ownership of the monopoly network to cross-subsidise its electricity supply business, if it does not charge for the use of its network.
- 41 Further, if BHP attempted to prevent another retailer from supplying Duke by refusing to enter into a use-of-system agreement or insisting on onerous terms in such an agreement, BHP would be at risk under both section 36 of the Commerce and section 68 of the EIR Act.
- 42 Therefore, the Commission considers that BHP's incentives and opportunities to inhibit competitive electricity supply are no more than minimal. The Commission concludes that 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 BHP 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?

- 43 As the result of the sale of its electricity generation assets to Duke, BHP is no longer involved in electricity generation. Therefore this criterion is not relevant to the Commission's decision.

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<sup>9</sup> BHP's electricity supply business exceeds the statutory exemption level of 2.5 GWh per annum by a factor approaching 50.

## 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?

- 44 BHP 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 BHP's network by electricity retailers who wish to compete with BHP's electricity supply business. The relationship between BHP's electricity lines and supply businesses will not be at arms length.
- 45 However the Commission considers that the potential effects of the relationship not being at arms length can be tempered by the fact that BHP supplies line function services, to BOC and Duke, 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 likely to suborn the purposes of the EIR Act.

## THE COMMISSION'S DECISION

- 46 BHP's application passes the Commission's criteria for decision making in respect of exemptions for the EIR Act.
- 47 In making its decision the Commission notes that the facts revealed in BHP'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.
- 48 Therefore, having considered the stated criteria, the Commission exempts BHP from the application of section 17 of the EIR Act, subject to the terms and conditions specified in the Notice of Exemption.
- 49 Given this decision, there is no need for the Commission to consider part A of BHP's application for exemption.

## **NOTICE OF EXEMPTION**

The Commission, pursuant to section 81, exempts BHP New Zealand Steel Ltd from the application of section 17 of the Electricity Industry Reform Act 1998 in relation to a prohibited cross-involvement in an electricity lines business, being the electricity distribution networks owned and operated by BHP New Zealand Steel Ltd at its industrial and iron sand mine sites and an electricity supply business.

The exemption is subject to the following terms and conditions:

- (a) That if BHP New Zealand Steel Ltd commences supplying line function services or electricity to other than BOC Gases New Zealand Ltd or Duke Energy New Zealand Ltd or their assigns it notifies the Commission.
- (b) That BHP New Zealand Steel Ltd does not commence electricity generation for other than its own consumption.
- (c) That BHP New Zealand Steel Ltd advises the Commission of any increases or new charges which comprise any component of the electricity price it charges to BOC Gases New Zealand Ltd or Duke Energy New Zealand Ltd or their assigns.
- (d) That BHP New Zealand Steel Ltd does not introduce a charge for the use of its electricity lines business to any of the consumers it supplies with electricity.

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 13th day of May 1999

The Commission