



COMMERCE COMMISSION

Decision No. 603

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

TOP ENERGY LIMITED

The Commission:

D R Bates
D F Curtin

**Summary of the
Application:**

Application by Top Energy Limited for exemption from section 17 of the EIR Act in respect of certain prohibited cross-involvements that would result from a proposed investment in a non-renewable generation plant.

Determination:

The Commission, pursuant to s81 of the EIR Act, determines to grant an exemption from s17 on the conditions specified in the Notice of Exemption.

Date of Determination:

10 May 2007

Date of Exemption:

This exemption takes effect upon publication in the New Zealand Gazette.

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EXECUTIVE SUMMARY

Introduction

- 1 On 9 November 2006, the Commerce Commission (the Commission) registered an application (the Application) from Top Energy Limited (Top) for exemption from section 17¹ of the Electricity Industry Reform Act 1998 (the EIR Act).
- 2 Top is an electricity lines company whose network covers the Northland region. In addition, Top, through its wholly owned subsidiary, Ngawha Generation Limited (NGL) owns and operates the Ngawha 12 MW (name plate) geothermal power plant at Ngawha Springs, 6 kilometres from Kaikohe (Ngawha).
- 3 Top has a statutory exemption for its existing 12MW of generation through section 19(3)(ga) of the EIR Act, which essentially provides that a person may be cross-involved in a lines business and a supply business that has up to 12 MW of geothermal generation, providing the generation was commissioned between 1 January 1998 and the date on which section 19(3)(ga)(i) came into force.
- 4 An exemption is sought to enable Top to expand the nameplate capacity of Ngawha by up to 30 MW to result in a new nameplate capacity of up to 42 MW. Top has gained the relevant resource consents for the proposal, and has also recently entered into supply and engineering, procurement and construction contracts for the proposal.

The Commission's Criteria

- 5 In considering an exemption from the EIR Act the Commission has regard to the purposes of the Act and the extent to which granting the exemption would promote or inhibit these purposes.
- 6 To do this the Commission obtains and evaluates objective answers to the following questions in relation to the particular purpose of Parts 1 to 5 of the EIR Act:
 - Would the Commission, by granting an exemption in respect of a business or involvement or interest, create incentives or opportunities to inhibit competition in the electricity industry?;
 - Would the Commission, by granting an exemption in respect of a business or involvement or interest, create incentives or opportunities to cross-subsidise generation activities from electricity lines businesses?; 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?

Incentives or Opportunities to Inhibit Competition in the Electricity Industry

- 7 The Commission is of the view that, in respect of the national electricity generation and wholesaling market and the relevant regional electricity distribution market, granting an exemption in this case would not create incentives or opportunities for Top to inhibit competition.
- 8 Further, the Commission considers that an exemption would not create an incentive or opportunity to inhibit competition in respect of the electricity retail markets, as neither

¹ Section 17 prohibits a person from being cross-involved in an electricity lines business and an electricity supply business.

Top nor NGL will be involved in selling electricity to end-use customers connected to Top's network.

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

- 9 The Commission considers that granting a limited exemption from the Arms Length Rules² in this case would not create incentives or opportunities (that did not already exist) to cross subsidise between lines activities and generation activities.
- 10 The Commission considered whether the ability to mis-allocate cost from the generation business to the lines business might be increased as a result of granting a limited exemption (but still requiring compliance with rules one to six and 11 to 15 of the Arms Length Rules) and considers that the likely degree of any such increase would not be material.

Creation of a Relationship not at Arms Length

- 11 The Commission considers that, as the exemption is unlikely to create incentives or opportunities to inhibit competition in the electricity industry or to cross-subsidise generation activities from electricity lines businesses, a limited exemption from the Arms Length Rules in this case is unlikely to have a material adverse effect on the purposes of the EIR Act.

Determination

- 12 The Commission determines to grant an exemption from s17 of the EIR Act, in respect of the cross-involvements outlined in the application subject to the following terms and conditions:
 - a director must be appointed to the Board of NGL who must not be:
 - a) a manager of Top;
 - b) an associate of Top, other than by virtue of being a director of NGL; or
 - c) involved in the business of Top;
 - NGL and Top's electricity lines business must comply with rules 1 to 6 and 11 to 15 of the Arms Length Rules set out in Schedule 1 of the EIR Act;
 - Top must not be involved either directly or indirectly in the selling of electricity to any end-use customer connected to Top's electricity network. This does not preclude the sale of electricity to an electricity retailer;
 - this exemption does not extend to engaging in the financial hedging of risks relating to the price of electricity in New Zealand beyond the nameplate generation capacity (42MW per annum) of the proposed expanded geothermal generation plant; and
 - this exemption is specific to the cross-involvements created through Top's involvement in the proposed expanded geothermal generation plant at Ngawha. It does not extend to any other interest, or existing or future cross-involvement of Top.
- 13 The exemption takes effect from the date of its publication in the New Zealand Gazette.

² The Arms Length Rules set out the requirements for any person not complying with the ownership separation rules to operate at arms length. These are set out in full in Appendix 1 to this determination.

INTRODUCTION

- 1 On 9 November 2006, the Commerce Commission (the Commission) registered an application (the Application) from Top Energy Limited (Top) for exemption from section 17 of the Electricity Industry Reform Act 1998 (the EIR Act).
- 2 Top is an electricity lines company whose network covers the Northland region. In addition, Top, through its wholly owned subsidiary, Ngawha Generation Limited (NGL) owns and operates the Ngawha 12 MW (name plate) geothermal power plant at Ngawha Springs, 6 kilometres from Kaikohe (Ngawha).
- 3 Top has a statutory exemption for its existing 12MW of generation through section 19(3)(ga) of the EIR Act, which essentially provides that a person may be cross-involved in a lines business and a supply business that has up to 12 MW of geothermal generation, providing the generation was commissioned between 1 January 1998 and the date on which section 19(3)(ga)(i) came into force.
- 4 An exemption is sought to enable Top to expand the nameplate capacity of Ngawha by up to 30 MW to result in a new nameplate capacity of up to 42 MW.

COMMISSION PROCEDURES

General

- 5 For the purpose of considering this application for exemption, the Commission, in terms of s73 of the Crown Entities Act 2004, has delegated its powers under s81 of the EIR Act to D R Bates QC and D F Curtin, Commissioners.

Criteria Used by the Commission to Consider Exemption Applications

- 6 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.3.³
- 7 The Commission stated in Practice Note No.3 that:

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

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

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

- (a) costs and prices in the electricity industry are subject to sustained downward pressure; and
- (b) the benefits of efficient electricity pricing flow through to all classes of consumers

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

by –

- (c) effectively separating electricity distribution from generation and retail; and
- (d) promoting effective competition in electricity generation and retail.

8 Practice Note No.3 states that :

On receipt of an application in the prescribed 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 questions in relation to the particular purpose of Parts 1 to 5 of the EIR Act:

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

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

- The relevant market(s)⁴ 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.

PARTIES

The Applicant

Top Energy Limited (Top)

- 9 Top owns and operates the local electricity distribution network in the Far North Region. It delivers 320GWh of electricity per annum to approximately 27,000 consumers. Top is wholly-owned by the Top Energy Consumers Trust (the Trust), the beneficiaries of which are Top's consumers.
- 10 The Top distribution network covers approximately 6,800 square kilometres. The geographic boundary is approximately 20 kilometres north of Whangarei at Hukerenui and equates to the Far North District Council territorial authority.
- 11 Top, through its wholly owned subsidiary Ngawha Generation Limited (NGL), owns and operates the Ngawha 12MW (name plate) geothermal power plant at Ngawha Springs, six kilometres from Kaikohe (Ngawha).

Other Parties

Interested parties

- 12 The Commission received submissions on the application from various parties including Genesis Power Limited and Meridian Energy Limited.

⁴ Defined using the same process as used for market definitions in respect of Commerce Act matters.

THE PROPOSAL

- 13 Top intends to expand the nameplate capacity of Ngawha by up to 30MW to result in a new nameplate capacity of up to 42MW. The proposed expansion will be connected directly to the local electricity distribution network. Top submitted that the generation will provide important voltage support in the region and would be capable of supplying the entire Kaikohe load. In addition, Top submitted that the generation will provide increased security in Auckland and the Far North District by reducing transmission loading from the South and, by virtue of generating reactive power, increasing transmission capacity from the South.
- 14 In selling the electricity generated, Top has an exclusive offtake agreement with Contact Energy Limited (Contact) which expires on 15 December 2008 and which is in respect of the existing electricity generated at Ngawha as well as any increased generation following expansion. The agreement is on a 'fixed price variable volume' basis, with the price set as part of the agreement, and with no link to the spot price.
- 15 Top is agreeable to the imposition of a condition to the exemptions sought that it not become involved directly or indirectly in retailing electricity, other than through the existing offtake agreement or any similar succeeding agreement.
- 16 Top made the following applications under section 81 of the EIR Act:
 - a) that the Trust be exempted from section 17 of the EIR Act;
 - b) that the trustees of the Trust, to the extent necessary, be exempted from section 17 of the EIR Act; and
 - c) that Top, NGL and its representative directors be exempted from the requirement to comply with the Arms Length Rules as required by section 46C(2) of the EIR Act or, in the alternative, be exempted from the requirement to comply with clauses 7, 8, 9 and 10 of the Arms Length Rules which, in general terms, relate to the appointment of directors and managers.

APPLICATION OF THE ACT

Electricity Lines Business Involvements

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

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

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

Electricity Supply Business Involvements

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

5. Meaning of ‘electricity supply business’

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

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

- (2) None of the following activities brings a person within subsection (1):
 - (a) Selling or generating less than 2.5 GWh per annum;
 - (b) Generating or selling electricity solely for its own consumption or for the consumption of its associates;
 - (c) Generating electricity solely for the consumption of a local community, where -
 - (i) The generator is owned or operated by a business that also conveys electricity by line; and
 - (ii) Both those lines and that generator are not connected, directly or indirectly, to the national grid;
 - (d) Selling electricity that is generated at a generator referred to in paragraph (c) or subsection (3);
 - (e) Generating electricity from distributed generation, and selling the electricity generated, where –
 - (i) the generating capacity of the distributed generation is no more, at any one time, than the greater of 5MW (determined according to the nameplate or nameplates) and 2% of the maximum demand, in the immediately preceding

financial year, of the system to which the distributed generation is connected;
and

- (ii) the distributed generation is owned or operated by a business that also conveys electricity by line and that distributed generation is connected to those lines:
- (f) Selling financial transmission rights that hedge risks arising from the effects of losses and constraints on the national grid:
- (g) Owning or operating, directly or indirectly, a generator referred to in any of the paragraphs (b) to (f) or subsection (3) or any other core generation assets used in connection with those generators.

22 Through the proposed expansion of the Ngawha geothermal plant, Top would be deemed to be an electricity supply business by way of s5(1)(a)(i) and (iii) and also through 5(1)(b) and 5(1)(c)(ii). Through its proposed arrangement in respect of the exclusive offtake agreement with Contact, the Commission also considers that Top would be deemed to be an electricity supply business pursuant to s5(1)(a)(ii).

23 Accordingly, the proposal would result in Top being an electricity supply business.

Cross-Ownership Prohibition

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

17. Cross-ownership prohibition –

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

Exemption for Generation Commissioned After 20 May 2003

25 The Act was amended in 2004 with the intention of relaxing the principle of ownership separation to allow for cross-ownership to exist in particular circumstances with respect to generation from sources other than a new renewable energy source. The amendment, which exists as s46C of the EIR Act, was designed to facilitate the investment by lines companies in new non-renewable generation and provides as follows:

46C. Exemptions for generation commissioned after 20 May 2003 and for reserve energy –

- (1) The following activities do not cause any person to be in breach of the ownership separation rules:
 - (a) generating electricity from generation commissioned on or after 20 May 2003, and selling the electricity generated, if the generating capacity of the generation is no more, at any one time, than the greater of 50MW (determined according to the nameplate or nameplates) or 20% of the maximum demand, in the immediately preceding financial year, on the lines owned or operated by the person:
 - (b) generating reserve energy and selling the electricity generated in accordance with the terms and conditions for that reserve energy set by the Commission, as those terms are defined in the electricity Act 1992.
- (2) Subsection (1) applies only if and as long as sections 24 and 25 (corporate separation and the arms length rules) are complied with.

26 Top is proposing to invest in a geothermal generation plant. As the proposal relates to a generation plant that has an aggregate generating capacity of more than 5MW it cannot be considered generation from a new renewable energy source as that term is defined in s46(A)(4), as s46(A)(4)(b) allows no more than 5MW of geothermal generation, unless approved by the Minister under s46(A)(3). Instead the proposal is subject to s46C and

Top is deemed not to be in breach of the cross-ownership provisions (subject to s46C(1)(a)) in so far as the proposal relates to:

- the generation of electricity by the geothermal generation plant; and
- the selling of that electricity.

27 However, as provided by s46C(2), the exception applies only if the corporate separation and arms length provisions in sections 24 and 25 of the EIR Act are complied with. Further, regardless of the operation of s46C, the Commission considers that Top, through the proposal, would still be in breach of the cross-ownership prohibition in s17 by way of the hedge arrangements to be entered into through its contract with an electricity retailer.

Corporate Separation and Arms Length Rules

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

24. Corporate separation–

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

29 Section 25 refers to the requirement to comply with the Arms Length Rules:

25. Arms length rules –

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

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

The Meaning of Cross Involvement

31 Section 7(1) of the EIR Act defines “involved” :

7. Meaning of ‘involved’

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

32 Section 11 of the EIR Act defines “material influence” :

- (1) Without limiting the ordinary meaning of the expression “material influence”, the following people are deemed to have material influence over an electricity business:
 - (a) A manager of a person that carries on the business:
 - (b) If the business is carried on by a natural person, that person:

- (c) A person in accordance with whose directions, instructions, or wishes a person referred to in either of paragraph (a) or paragraph (b), or the business, may be required or is accustomed to act in respect of the carrying on or management of the business:
- (d) A person that exercises or that is entitled to exercise, or who controls or is entitled to control the exercise of, powers which would ordinarily fall to be exercised by a person referred to in either of paragraph (a) or paragraph (b):
- (e) A person that can appoint or remove, or control the appointment or removal of, a person referred to in either of paragraph (a) or paragraph (b):
- (f) A person that has a power to influence a decision of the business which would ordinarily require the holding of control rights which would cause the person to exceed the 10% threshold:
- (g) A person in circumstances where that person and the business is acting, or proposing to act, jointly or in concert in relation to the business; or
- (h) A person that, under a trust or agreement (whether or not the person is a party to it), may at any time have any of the powers referred to in paragraph (c) to paragraph (f).

(2) Where a person has material influence over an electricity business under this section, and another person has any of the powers or controls referred to in paragraph (c) to paragraph (h) in relation to the first person or the majority of its managers, then that other person is deemed also to have material influence over the business, and so on. (3) A person is deemed to have material influence over an electricity business if the person is one of 2 or more associates who, together, have material influence over the business.

(4) Subsection (3) does not apply to deem a person to have material influence over a business only because that person is, under section 12(1)(b) or (c), an associate of another person, provided those associates act in accordance with the arms length rules (with all necessary modifications) in respect of the business.

(5) For the avoidance of doubt, a power to cast one of many votes at an election of trustees or councillors does not, of itself, constitute material influence.

33 The Commission considers that all parties deemed to be involved in both Top's electricity lines business and Top's proposed involvement in an electricity supply business would be deemed to be cross involved themselves. This would extend, but is not necessarily limited to, the directors of Top who, it is proposed, will also sit on the board of the electricity supply business.

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

19. Certain businesses and involvements to be disregarded

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

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

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

The Commission's Exemption Power

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

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

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

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

Summary of Application of the EIR Act and Cross-Involvements

- 37 The s46C exemption from complying with the ownership separation provisions in s17 is contingent on Top complying with:
- the corporate separation provisions in s24; and
 - the arms length provisions in s25 and schedule 1.
- 38 The proposal would also breach the ownership separation rules in so far as Top wishes to enter into a financial hedge arrangement with an electricity retailer.
- 39 Therefore, Top has sought an exemption from s17 of the EIR Act to enable it to operate its electricity lines business and manage its investment in the proposed geothermal generation plant in a manner that is other than at arms length, and to enter into hedge arrangements (by way of a fixed price variable volume contract) with an electricity retailer.

THE COMMISSION'S EXEMPTION POWER IN RELATION TO S46C

- 40 Given the statutory exemption allowing lines companies to invest in new non-renewable generation in s46C and the requirement to comply with the Arms Length Rules in s46C(2), the Commission considered whether it would be appropriate to exercise its discretionary power to applications seeking exemption from compliance with the Arms Length Rules.
- 41 The Commission's discretionary power to grant exemptions under s81 is in addition to the limited statutory exemption under s46C and the Commission considers that the questions stated in the Commission's Practice Note No.3 continue to be the relevant questions in assessing applications for s81 exemption from the EIR Act and the appropriate questions to address in this case.

EXAMINATION IN TERMS OF THE COMMISSION'S CRITERIA

- 42 The Commission is of the view that the relevant markets in this instance are the national electricity generation and wholesaling market and the electricity distribution market that corresponds with Top's electricity distribution network.

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

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

- 43 As stated in the Commission's Practice Note No.3, the Commission considers this question in respect of the relevant markets within the electricity industry.
- 44 The relevant markets for the consideration of this application are:⁵
- the regional electricity distribution market in the Far North of the North Island (geographically defined by the boundary of the Top distribution network in that area);⁶ and

⁵ Other markets in the electricity industry, for example the electrical construction and maintenance market and the market for reticulation of new subdivisions, do not appear to be relevant to this application for exemption.

- the national electricity generation and wholesaling market.⁷

45 The Commission considers that, as Top will not be involved in the selling of electricity to anyone connected to Top's distribution network (other than to an electricity retailer), an analysis of either a national or regional electricity retailing markets is unnecessary.

Regional Electricity Distribution Markets

46 The regional electricity distribution market that is relevant to this application is the Far North District, being the region where Top is the network operator.

47 Local electricity distribution networks are characterised by being regional natural monopolies. The granting of this exemption would not affect the level or existing competition or scope for potential competition within those markets.

48 Accordingly, the granting of an exemption would not, in respect of this market, create incentives or opportunities to inhibit competition.

National Electricity Generation and Wholesaling Market

49 In Decision 591⁸ the Commission considered that the proposal of Westpower Limited (Westpower) was unlikely to provide incentives or opportunities for Westpower to inhibit competition in this market. In that case the Commission also considered that Westpower would be unlikely to have any market power in respect of the contract for differences it was proposing to enter and that the hedge price in the contract would be constrained by the spot price for electricity at the grid exit point to which the contract applied.

50 Similar to the Westpower case is the fact that Top proposes to connect its generation to the local distribution network and sell the electricity through a hedge arrangement with an electricity retailer.

51 The Commission has considered whether there would be an incentive for Top to, in some way, favour its contractual partner in respect of lines access and treatment. However, the Commission considers that there is no incentive for Top to do this, as once the contract has been finalised (and the price set) there is no ability for Top to manipulate its financial position under it by favouring the counterparty in respect of lines services or otherwise.

52 Further, the Commission considers that the proposal to enter into a fixed price variable volume contract as outlined in the proposal will not create incentives or opportunities for Top to inhibit competition in respect of the national generation and wholesaling market.

53 Accordingly, the Commission considers that the connection of the generation to Top's distribution network, and the sale of electricity through a contractual arrangement as described, will not create incentives or opportunities for Top to inhibit competition in the national generation market.

⁶ For discussion of electricity distribution market definition see Decision 345, United Networks Limited / Transalta New Zealand Limited, 11 March 1999 and Decision 299, Holdco (Mercury Energy Ltd and Utilicorp) / Power New Zealand Ltd, 27 June 1997.

⁷ For a discussion of electricity generation market definition see Decision 340, Transalta Corporation of Canada / Contact Energy, 12 February 1999 and Decision 491, Contact Energy Limited / Natural Gas Corporation Holdings Limited, 04 February 2003.

⁸ Decision 591, *Westpower Limited*, 25 October 2006.

Conclusion on Question 1

- 54 The Commission is of the view that, in respect of the national electricity generation and wholesaling market, and in respect of the regional⁹ electricity distribution market the granting of an exemption in this case would not create incentives or opportunities for Top to inhibit competition.

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

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

- 55 The Commission considers that a lines business which is also engaged in generation has the opportunity to cross-subsidise its generation business, should it choose to do so. Cross-subsidisation could take a number of forms. It may be that the lines business would meet costs which more properly lie with the generation side of the business. It may be that common costs would all be attributed to the lines business. It may be that the lines business would provide capital to the generation business at less than its true cost. It may be that the generation project would be funded in a way which weakens the financial stability of the lines business.
- 56 Any of these possibilities of cross-subsidisation could increase upward pressure on lines charges.
- 57 In the Westpower decision, the Commission considered that the 80/20 proposed joint venture ownership structure would weaken the incentive to cross-subsidise, though this was not a factor which, on its own, would remove such incentives altogether. This incentive could arise from an attempt to see the overall business expand, possibly by providing a competitive advantage to the generation business. It is possible that an incentive to cross-subsidise would arise from a desire to make the regulatory regime for lines businesses less effective by ‘hiding’ lines profits in the generation business.
- 58 As NGL is a wholly owned subsidiary of Top, there is no joint venture ownership structure to weaken any incentive to cross-subsidise¹⁰. The Commission considers that in order to weaken any incentive to cross-subsidise, it may be appropriate to require that an independent director be appointed to the Board of NGL, though, again, this is not a factor which, on its own, would remove such incentives altogether.
- 59 The Commission has considered the extent to which incentives or opportunities to cross-subsidise (by way of misallocation of costs) might be created or increased as a result of granting an exemption. Top submitted that a key reason for requiring the exemption is to maintain the existing governance structure for NGL since the current directors and managers operate Ngawha and are thoroughly familiar with Ngawha, the details of its operation and the risks it is required to manage as well as the proposal to increase its capacity. The Commission considers that a limited exemption to allow this to occur, whilst retaining the obligation to comply with the balance of the Arms Length Rules, is appropriate. The Commission considers that this would limit the extent to which incentives or opportunities (to misallocate costs) would be increased by the exemption, to

⁹ Specifically the region where Top is the network operator.

¹⁰ The Commission is aware that there may be a potential joint venture partner for the proposed expansion to Ngawha. At the date of this determination, it was unclear whether there would be a joint venture partner and, therefore, the analysis has been undertaken assuming that there will be no joint venture partner.

a level that is not material, particularly considering the relatively small size of the proposed generation asset.

- 60 Accordingly, the Commission considers that a condition of any exemption granted should be the requirement to observe the Arms Length Rules numbered 1 to 6 and 11 to 15.
- 61 Further, the Commission has considered the extent to which an exemption might enable a direct financial cross-subsidisation between the lines business and generation business, or whether such a relationship would enable the lines business to incur risk that would be more properly incurred by the generation business. The Commission considers that these opportunities and incentives, to the extent that they exist at present, would not be created by the Commission granting a limited exemption in this instance. Section 46C allows cross-ownership of lines businesses and non-renewable generation (such as is proposed by the Applicant), as long as the corporate separation and arms length provisions are complied with. The opportunity or incentive to cross-subsidise is an effect of cross-ownership that is authorised by s46C. If a lines company invested in generation and complied with the corporate separation and arms length provisions, no exemption would be required¹¹, but the risk of cross-subsidisation identified above would still exist.
- 62 Accordingly, the Commission does not consider that a limited exemption would materially affect the incentive or opportunity to cross-subsidise the generation activity proposed by Top. The Commission notes that this view would not change, if Top had a joint venture partner for the expansion of Ngawha.

Conclusion on Question 2

- 63 The Commission considers that the granting of an exemption from the Arms Length Rules in this case would not create incentives or opportunities (that do not already exist) to cross subsidise between lines activities and generation activities.
- 64 The Commission considered the extent to which the ability to misallocate costs from the generation business to the lines business might be increased as a result of granting a limited exemption (requiring compliance with 1 to 6 and 11 to 15 of the Arms Length Rules, and requiring the appointment of an independent director to the Board of NGL) and considers that any such increase would not be material.

Question 3: A Relationship Not at Arms Length

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

- 65 In most circumstances where an exemption is required from the ownership separation provisions of the EIR Act, a relationship will be created that will ultimately not be at arms length. In each case the Commission assesses the practical effect of the non-arms length relationship in order to decide whether that relationship is likely to lead to a result that would be contrary to the purposes of the EIR Act.
- 66 This Application specifically seeks exemption from the necessity to comply with the Arms Length Rules.

¹¹ On the assumption that the lines company was not proposing to sell a financial hedge for risks relating to the price of electricity.

- 67 Previously, the Commission has determined that where the granting of an exemption would not create incentives or opportunities to inhibit competition in the electricity industry or would not create incentives or opportunities to cross-subsidise generation activities from electricity lines businesses then the arms length requirement may have no practical effect.
- 68 In this case s46C(2) of the EIR Act requires, where lines companies seek to invest in non-renewable generation, that the Arms Length Rules be complied with. Whilst the Commission considers that strict compliance with these rules is necessary in instances where the lines business is also proposing to retail the generated electricity across its own lines, that is not what is proposed in the present case.
- 69 Top has submitted that it wishes to retain the existing governance structure of NGL in order to utilise the experience and knowledge of the directors and managers, as stated above.
- 70 The Commission considers that a limited exemption to allow the retention of the current governance structure of NGL, subject to the appointment of an independent director to the Board of NGL, is appropriate in this case whilst maintaining the existing requirement to otherwise comply with the Arms Length Rules.

Conclusion on Question 3

- 71 The Commission considers that as the exemption is unlikely to create incentives or opportunities to inhibit competition in the electricity industry or to cross-subsidise generation activities from electricity lines businesses, a limited exemption from the requirement to comply with rules 7-10 of the Arms Length Rules in this case is unlikely to have any material adverse effect.

Conclusion in Respect of the Commission's Criteria

- 72 The Commission considers that the granting of a limited exemption in this case would not create incentives or opportunities to inhibit competition in the electricity industry.
- 73 The Commission also considers that limiting the exemption to Arms Length Rules 7 to 10 only would not result in any material increase in the opportunities or incentives to cross subsidise generation activities from lines activities.
- 74 Further, the Commission considers that the exemption would create a relationship between an electricity supply business and an electricity lines business that is other than at arms length but that that relationship, due to the above considerations, would have no practical effect on the purposes of the EIR Act.
- 75 Accordingly, the Commission determines to grant a limited exemption to Top from s17 of the EIR Act in respect of the cross-involvements outlined in the application, subject to the following conditions:
- a director must be appointed to the Board of NGL who must not be:
 - a) a manager of Top;
 - b) an associate of Top, other than by virtue of being a director of NGL; or
 - c) involved in the business of Top;
 - NGL and Top's electricity lines business must comply with rules 1 to 6 and 11 to 15 of the Arms Length Rules set out in Schedule 1 of the EIR Act;

- Top must not be involved either directly or indirectly in the selling of electricity to any end-use customer connected to Top's electricity network. This does not preclude the sale of electricity to an electricity retailer;
- this exemption does not extend to engaging in the financial hedging of risks relating to the price of electricity in New Zealand beyond the nameplate generation capacity (42MW per annum) of the proposed expanded geothermal generation plant; and
- this exemption is specific to the cross-involvements created through Top's involvement in the proposed expanded geothermal generation plant at Ngawha. It does not extend to any other interest or existing or future cross-involvement of Top.

76 The exemption takes effect from the date of its publication in the New Zealand Gazette.

THE COMMISSION'S DETERMINATION

77 The Commission determines to grant a limited exemption from particular Arms Length Rules of the EIR Act, subject to the terms and conditions stated in the Notice of Exemption.

Dated this 10th day of May 2007

Donal Curtin
Commissioner
Commerce Commission

NOTICE OF EXEMPTION

The Commerce Commission (Commission), pursuant to section 81 of the Electricity Industry Reform Act 1998 (the EIR Act), exempts Top Energy Limited (Top) from the application of section 17 of the EIR Act in respect of the cross-involvement (as that term is defined in the EIR Act) that would be created through its investment in a geothermal generation plant, located at Ngawha Springs, Northland, through Top's wholly owned subsidiary Ngawha Generation Limited (NGL) outlined in its application for exemption registered by the Commission on 9 November 2006.

The exemption is subject to the following conditions:

1. a director must be appointed to the Board of NGL who must not be:
 - a. a manager of Top;
 - b. an associate of Top, other than by virtue of being a director of NGL; or
 - c. involved in the business of Top;
2. NGL and Top's electricity lines business must comply with rules 1 to 6 and 11 to 15 of the Arms Length Rules set out in Schedule 1 of the EIR Act;
3. Top must not be involved either directly or indirectly in the selling of electricity to any end-use customer connected to Top's electricity network. This does not preclude the sale of electricity to an electricity retailer;
4. this exemption does not extend to engaging in the financial hedging of risks relating to the price of electricity in New Zealand beyond the nameplate generation capacity (42MW per annum) of the proposed expanded geothermal generation plant; and
5. this exemption is specific to the cross-involvements created through Top's involvement in the proposed expanded geothermal generation plant at Ngawha. It does not extend to any other interest or existing or future cross-involvement of Top.

The exemption takes effect from the date of publication of this notice in the New Zealand Gazette.

The Commission may vary or revoke the exemption in accordance with s81(5) of the EIR Act.

Dated this 10th day of May 2007

Donal Curtin
Commissioner

APPENDIX 1

ARMS LENGTH RULES

1. Objective—

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

2. Arms length rules—

The arms length rules are as follows:

Duty to Ensure Arms Length Objective Is Met

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

Arms Length Terms

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

Duty Not to Prefer Interests of Business B

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

Duty Not to Discriminate in Favour of Business B

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

Duty to Focus on Interests of Right Ultimate Owners

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

Duty of Managers of Parents of Business A

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

Requirement for Separate Management

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

Restriction on Use of Information

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

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

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

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

Records

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

Practical Considerations

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