



COMMERCE COMMISSION

Decision No. 608

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:

THE LINES COMPANY LIMITED

The Commission:

P R Rebstock
D R Bates
D F Curtin

**Summary of the
Application:**

Application by The Lines Company Limited for exemption from rules 7 to 10 of the Arms Length Rules of the EIR Act in respect of certain prohibited cross-involvements that would result from a proposed investment in a new renewable generation plant.

Determination:

The Commission, pursuant to s 81 of the EIR Act, determines to grant a limited exemption from compliance with s 17 on the conditions specified in the Notice of Exemption.

Date of Determination:

19 October 2007

Date of Exemption:

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

CONFIDENTIAL MATERIAL IN THIS REPORT IS CONTAINED IN SQUARE BRACKETS

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EXECUTIVE SUMMARY

Introduction

- 1 On 5 March 2007, the Commerce Commission (the Commission) registered an application (the Application) from The Lines Company Limited (TLC) for exemption from rules 7 to 10 of the Arms Length Rules¹ of the Electricity Industry Reform Act 1998 (the EIR Act).
- 2 TLC is an electricity lines business whose network is located in the King Country region. TLC is 90% owned by the Waitomo Energy Services Customer Trust and 10% owned by the King Country Electric Power Trust.
- 3 TLC is proposing to construct a 2 MW hydro generation plant on the Waikohu Stream near 755 Oliver Road, Matawai (Matawai Scheme), which is between Opotoki and Gisborne. This is not on TLC's local distribution network, rather, the generation will be connected to Eastland Network Limited's (Eastland's) electricity distribution network.
- 4 The Matawai Scheme will be implemented through Matawai Hydro Limited (MHL), a company incorporated for the specific purpose of running the Matawai Scheme and owning the assets associated with the scheme. Initially, TLC will be a 100% shareholder of MHL, but TLC anticipates, once construction commences, that the Rata Hills Trust (the private landowner of the site of the scheme) will purchase a [] share in MHL.
- 5 TLC is applying, under section 81 of the EIR Act, for exemption from the requirement to comply with rules 7 to 10 of the Arms Length Rules which, in general terms, relate to the appointment of independent directors and managers.

The Commission's Criteria

- 6 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.
- 7 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

- 8 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

¹ The Arms Length Rules are contained in Schedule 1 of the EIR Act and 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. Rules 7 to 10 of the Arms Length Rules, in general terms, relate to the appointment of independent directors and managers.

exemption in this case would not create incentives or opportunities for TLC to inhibit competition, particularly given the size of the proposed generation plant falls within the 5 MW limit referred to in s 46A of the EIR Act.

- 9 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 TLC nor MHL will be involved in selling electricity to end-use customers connected to TLC's network.

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

- 10 The Commission considers that granting a limited exemption from s 17 of the EIR Act in this case would not create incentives or opportunities (that did not already exist) to cross subsidise between lines activities and generation activities.
- 11 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 from s 17 (but still requiring compliance with rules 1 to 6 and 11 to 15 of the Arms Length Rules) and considers that the likely degree of any such increase would not be material, given that the proposed generation plant would not be located on TLC's electricity network and there would be limited opportunity for this to occur.

Creation of a Relationship not at Arms Length

- 12 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 s 17 in this case is unlikely to have a material adverse effect on the purposes of the EIR Act.

Determination

- 13 The Commission determines to grant a limited exemption from s 17 of the EIR Act, in respect of the cross-involvements outlined in the Application subject to the following terms and conditions:
- TLC will ensure that no more than two thirds of the Board of Directors of MHL are directors who are either:
 - a) a manager of TLC;
 - b) an associate of TLC, other than by virtue of being a director of MHL; or
 - c) involved in the business of TLC;
 - MHL and TLC'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;
 - TLC must not be involved either directly or indirectly in the selling of electricity generated by the Matawai Scheme to any customer connected to TLC's electricity network. This does not preclude the selling of electricity either into the New Zealand Wholesale Electricity Market, or to an electricity retailer for the purpose of supplying retail customers, whether those retail customers are connected to TLC's electricity network or otherwise;
 - any generation asset to which this application relates must not be connected to electricity lines owned or operated by TLC except to the extent that is necessary in order to connect the generation asset to the local distribution network; and

- this exemption is specific to the cross-involvements created through TLC's involvement in MHL for the purposes of developing the proposed hydro generation plant at Matawai. It does not extend to any other interest, or existing or future cross-involvement of TLC.

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

INTRODUCTION

- 1 On 5 March 2007, the Commerce Commission (the Commission) registered an application (the Application) from The Lines Company Limited (TLC) for exemption from rules 7 to 10 of the Arms Length Rules of the Electricity Industry Reform Act 1998 (the EIR Act).
- 2 TLC is an electricity lines business whose network is located in the King Country region. TLC is proposing to construct a 2 MW hydro generation plant on the Waikohu Stream near Matawai (Matawai Scheme), which is between Opotoki and Gisborne. The generation will be connected to Eastland Network Limited's (Eastland's) electricity distribution network.
- 3 The Matawai Scheme will be implemented through Matawai Hydro Limited (MHL), a company incorporated for the specific purpose of running the Matawai Scheme and owning the assets associated with the scheme. Initially, TLC will be a 100% shareholder of MHL, but TLC anticipates, once construction commences, that the Rata Hills Trust (the private landowner of the site of the scheme) will purchase a [] share in MHL.
- 4 TLC is applying, under s 81 of the EIR Act, for exemption from the requirement to comply with rules 7 to 10 of the Arms Length Rules which, in general terms, relate to the appointment of independent directors and managers.

COMMISSION PROCEDURES

General

- 5 For the purpose of considering this application for exemption, the Commission, in terms of s 73 of the Crown Entities Act 2004, has delegated its powers under s 81 of the EIR Act to P R Rebstock, D R Bates QC and D F Curtin, Commission members.

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.3.²
- 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

² Commerce Commission, *Practice Note No.3: Electricity Industry Reform Act 1998 Commission's Role and Processes*, September 1998.

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.

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)³ 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.

9 In the particular circumstances of this case, the Commission decided to invite submissions on the Application. The Commission received no submissions on the Application.

PARTIES

The Applicant

The Lines Company Limited (TLC)

- 10 TLC owns and operates the local electricity distribution network in the King Country region, which covers approximately 13,700 square kilometres. It delivers 300GWh of electricity per annum to approximately 20,000 consumers.
- 11 TLC is 90% owned by the Waitomo Energy Services Customer Trust and 10% owned by the King Country Electric Power Trust. The beneficiaries of these trusts are TLC's customers.

³ Defined using the same market definition process as applied in Commerce Act matters. See also Commerce Commission, *Mergers and Acquisitions Guidelines*, 1 January 2004.

Other Parties

Matawai Hydro Limited (MHL)

- 12 MHL is a company incorporated for the specific purpose of running the proposed Matawai Scheme and owning the assets associated with the scheme.

Rata Hills Trust

- 13 The Rata Hills Trust is the private landowner of the proposed site of the Matawai Scheme.

THE PROPOSAL

- 14 TLC is proposing to construct the Matawai Scheme, a 2 MW hydro generation plant on the Waikohu Stream near 755 Oliver Road, Matawai, which is between Opotoki and Gisborne. This is not on TLC's local distribution network, rather, the Matawai Scheme will be connected to Eastland's electricity distribution network.
- 15 The Matawai Scheme will be implemented through MHL. Initially, TLC will be a 100% shareholder of MHL, but TLC anticipates, once construction commences, that the Rata Hills Trust will purchase a [] share in MHL. As part of purchasing a [] share of MHL, it is intended that the Rata Hills Trust will appoint one out of three directors to the board of MHL, with the remaining two directors being appointed by TLC.
- 16 Neither TLC nor MHL are intending to enter the electricity retail market. No specific contract is currently in place in relation to the sale of electricity from the proposed generation plant. However, TLC (and MHL) intend to sell the output of the Matawai Scheme to an electricity retailer by way of a fixed price variable volume contract, rather than selling to end-use customers or selling to the wholesale market.
- 17 TLC has applied, under s 81 of the EIR Act, for exemption from the requirement to comply with rules 7 to 10 of the Arms Length Rules (which, in general terms, relate to the appointment of independent directors and managers), to enable it to draw on its existing in-house expertise in relation to the ownership and management of hydro-generation assets.

APPLICATION OF THE EIR ACT

Electricity Lines Business Involvements

- 18 The definition of "electricity lines business" appears in s 4(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.

- 19 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.

20 TLC falls within the above definition in s 4(1)(a) and (b) and is not excepted by s (4)(2). Accordingly, TLC is an electricity lines business.

Electricity Supply Business Involvements

21 The EIR Act provides for the definition of “electricity supply business” in s 5(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.

22 Subsection (2) provides for a number of exemptions from s 5(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 5 MW (determined according to nameplate or nameplates) and 2% of the maximum demand, in the immediately preceding financial year, of the lines 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 paragraphs (b) to (f) or subsection (3) or any other core generation assets used in connection with those generators.
- 23 In its application, TLC submitted that, through its proposed involvement in the Matawai Scheme, TLC would be deemed to be an electricity supply business by way of ss 5(1)(b) and (c).
- 24 The Commission considers that the proposal will result in MHL being an electricity supply business by way of ss 5(1)(a)(i) and (iii)⁴ and also through s 5(1)(b) and s 5(1)(c)(ii).
- 25 The Commission considers that the proposal will result in TLC being an electricity supply business by way of s 5(1)(b) and s 5(1)(c)(ii).
- 26 The Commission also considers that TLC will be “involved” in an electricity supply business for several reasons. First, TLC’s ownership interest in MHL would exceed the 10% threshold (s 7(1)(b)). Secondly, it is intended that TLC will have the right to appoint at least two directors to the Board of MHL and, therefore, TLC would be deemed to have material influence over the business of MHL (s 7(1)(c)).
- 27 Accordingly, the proposal would result in TLC being an electricity supply business by way of s 5(1)(b) and s 5(1)(c)(ii), and would also result in TLC being involved in the electricity supply business, MHL, by way of ss 7(1)(b) and (c).

Cross-Ownership Prohibition

- 28 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, s 17 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 new generation from new renewable energy source

- 29 The EIR Act was amended in 2001⁵ with the intention of relaxing the principle of ownership separation to allow for cross-ownership to exist in particular circumstances

⁴ Note, the Commission does not consider that TLC is an electricity supply business by way of s 5(1)(a)(ii). Although a fixed price variable volume contract can be used to manage risks relating to the price of electricity, the Commission does not consider it to be a financial hedge, as it is a contract for the physical supply and taking delivery of electricity, rather than allowing obligations under the contract to be settled by a payment of money without necessarily relating to actual supply.

⁵ Section 46A was further amended, as from May 2003, by omitting the word “distributed” wherever it appeared.

with respect to generation from a new renewable energy source. The amendment, which exists as s 46A of the EIR Act, was designed to facilitate the investment by lines companies in new renewable generation and provides as follows:

46A. Exemptions for new...generation from new renewable energy source

- (1) The following activities do not cause any person to breach the ownership separation rules:
 - (a) generating electricity from new...generation using only –
 - (i) a new renewable energy source; or
 - (ii) a new renewable energy source and fossil fuels if fossil fuels provide no more than 20% of the total fuel energy input for the generator or generators comprising the generation plant in any 12-month period or any larger amount approved by the Minister under subsection (3);
 - (b) selling electricity referred to in paragraph (a);
 - (c) owning or operating, directly or indirectly, new...generation, or any other core generation assets used in connection with new...generation, that is capable of generating electricity referred to in paragraph (a).
- (2) Subsection (1) applies only if and as long as sections 24 and 25 are complied with (corporate separation and arms length rules).
- (3) The Minister may increase the thresholds in subsection (1)(a)(ii) or in paragraph (b) of the definition of “new renewable energy source” to approve a particular activity for the purposes of subsection (1) (on the conditions, if any, he or she thinks fit) after first taking into account whether or not the generation uses new or advanced technology.
- (4) In this section, –

“**New...generation**” means...generation that is not existing on the date on which this section comes into force

“**New renewable source**” –

 - (a) means an energy source that occurs naturally and the use of which will not permanently deplete New Zealand’s energy sources of that kind, because those sources are generally expected to be replenished by natural processes within 50 years or less of being used; but
 - (b) does not include hydro or geothermal energy sources at a generator or generators comprising a generation plant that has an aggregate generating capacity (determined according to nameplate or nameplates) of more than 5 MW, unless approved by the Minister under subsection (3).
- (5) This section does not limit section 5(2)(e) (exclusion from definition of electricity supply business).

30 TLC and its subsidiary, MHL, are proposing to invest in a hydro generation plant. As the proposal relates to a generation plant that has an aggregate generating capacity of less than 5 MW it is considered to be generation from a new renewable energy source as that term is defined in s 46A(4). TLC is deemed not to be in breach of the cross-ownership provisions in so far as the proposal relates to:

- the generation of electricity by the hydro generation plant;
- the selling of that electricity; and
- the ownership or operation of the related generation assets.

31 However, as provided by s 46A(2), the exception applies only if the corporate separation and arms length provisions in ss 24 and 25 of the EIR Act are complied with. Further, regardless of the operation of s 46A, TLC, through the proposal, would still be in breach of the cross-ownership prohibition in s 17 through its proposal to enter into a contract to sell electricity to an electricity retailer (by way of a fixed-price variable-volume contract), as s 5(1)(c)(ii) of the EIR Act is not excepted by s 46A.

Corporate Separation and Arms Length Rules

32 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 different companies.

33 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 and that is exempt from complying with the ownership separation rules by reason of ...section 46A (new...generation from new renewable energy source), and every electricity 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.

34 Schedule 1 of the EIR Act sets out in detail what is meant by the Arms Length Rules in s 25. 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

35 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.

36 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.

37 The Commission considers that all parties deemed to be involved in both TLC's electricity lines business and TLC'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 TLC who, it is proposed, will also sit on the board of the electricity supply business, MHL.

38 If the Commission determined to grant an exemption for the proposal, any such involvements could be disregarded through the operation of s 19(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 s 81...

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

The Commission's Exemption Power

40 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

41 The s 46A exemption from complying with the ownership separation provisions in s 17 is contingent on TLC complying with:

- the corporate separation provisions in s 24; and
- the arms length provisions in s 25 and schedule 1.

42 The proposal would also breach the ownership separation rules in so far as TLC and MHL wish to enter into a contract to sell electricity to an electricity retailer.

- 43 Therefore, while TLC has sought an exemption from rules 7 to 10 of the Arms Length Rules requiring separate management of electricity lines and generation businesses, the Commission considers it more appropriate to consider a limited exemption from s 17, in order to enable TLC to operate its electricity lines business and manage its investment in the proposed hydro generation plant (via MHL) in a manner that is other than at arms length, and to enter into a fixed-price variable-volume contract with an electricity retailer.

THE COMMISSION'S EXEMPTION POWER IN RELATION TO SECTION 46A

- 44 Given the statutory exemption allowing lines companies to invest in new renewable generation in s 46A and the requirement to comply with the Arms Length Rules in s 46A(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.
- 45 The Commission's discretionary power to grant exemptions under s 81 is in addition to the limited statutory exemption under s 46A and the Commission considers that the questions stated in the Commission's *Practice Note No.3: Electricity Industry Reform Act 1998 Commission's Role and Processes*, September 1998⁶ (Practice Note No.3) continue to be the relevant questions in assessing applications for s 81 exemption from the EIR Act and the appropriate questions to address in this case.

EXAMINATION IN TERMS OF THE COMMISSION'S CRITERIA

- 46 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 TLC'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?

- 47 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.
- 48 The relevant markets⁷ for the consideration of this Application are:
- the regional electricity distribution market in the King Country of the North Island (geographically defined by the boundary of the TLC distribution network in that area);⁸ and
 - the national electricity generation and wholesaling market.⁹

⁶ Commerce Commission, *Practice Note No.3: Electricity Industry Reform Act 1998 Commission's Role and Processes*, September 1998

⁷ 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.

⁸ For discussion of electricity distribution market definition see Commerce Commission, *Decision 345: United Networks Limited / Transalta New Zealand Limited*, 11 March 1999 and Commerce Commission, *Decision 299: Holdco (Mercury Energy Ltd and Utilicorp) / Power New Zealand Ltd*, 27 June 1997.

- 49 The Commission considers that, in the case of the Matawai Scheme, as neither TLC nor MHL will be involved in the selling of electricity to anyone connected to TLC's distribution network (other than to an electricity retailer), analysis of either the national or a regional electricity retailing market is unnecessary.

Regional Electricity Distribution Markets

- 50 The regional electricity distribution market that is relevant to the Application is the King Country of the North Island, being the region where TLC is the network operator.
- 51 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.
- 52 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

- 53 TLC submitted that generation from the Matawai Scheme would amount to approximately 0.025% of the national wholesale electricity market in New Zealand and, therefore, TLC and MHL are unlikely to have any market power in respect of the national electricity generation and wholesaling market.
- 54 TLC and MHL do not intend to connect the generation to TLC's local distribution network, nor do they intend to sell the electricity generated to end-use customers.
- 55 In Decision 576¹⁰ the Commission considered that the proposal of Unison Networks Limited (Unison) (to connect wind farm generation to the national transmission network and sell the electricity it generates through the wholesale market) was unlikely to provide incentives or opportunities for Unison to inhibit competition in this market. That analysis was based on the assumption that the generation assets will not be connected to the distribution networks owned by Unison, so the Commission considered it appropriate to make the exemption it granted conditional on the generation assets not being connected to electricity lines owned or operated by Unison.
- 56 Similarly to the situation in Decision 576, TLC does not intend to connect the generation from the Matawai Scheme to its local distribution network, nor sell the electricity generated to end-use customers.
- 57 Further, in respect of TLC's proposal to enter into a fixed price variable volume contract, the Commission considered whether there would be an incentive for TLC, as the lines company, 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 TLC to do this. The Matawai Scheme is not on TLC's local distribution network, rather, the generation will be connected to Eastland's electricity distribution network. Once the contract has been finalised (and the price set) there is no ability for TLC to manipulate its financial position under it by favouring the counterparty in respect of lines service or otherwise.

⁹ For a discussion of electricity generation market definition see Commerce Commission, *Decision 340: Transalta Corporation of Canada / Contact Energy*, 12 February 1999 and Commerce Commission, *Decision 491: Contact Energy Limited / Natural Gas Corporation Holdings Limited*, 04 February 2003.

¹⁰ Commerce Commission, *Decision 576: Unison Networks Limited*, 15 March 2006.

- 58 An increase in the supply of electricity in the New Zealand market creates downward pressure on the wholesale price of electricity. However, in this case, the effect is likely to be minimal, given the size of the proposed hydro generation plant.
- 59 Accordingly, the Commission considers that the connection of the generation to Eastland's distribution network, and the sale of electricity through a contractual arrangement as described, will not create incentives or opportunities for TLC to inhibit competition in the national generation and wholesaling market.

Conclusion on Question 1

- 60 The Commission is of the view that, in respect of the national electricity generation and wholesaling market and in respect of the regional electricity distribution market where TLC is the network operator, the granting of an exemption in this case would not create incentives or opportunities for TLC to inhibit competition, particularly given the size of the proposed generation plant falls within the 5 MW limit referred to in s 46A of the EIR Act.
- 61 The Commission considers that it is appropriate to make any exemption granted in this case conditional on the following:
- TLC must not be involved directly or indirectly in the retailing of electricity generated by the Matawai Scheme to any customer connected to TLC's electricity network. This does not preclude the selling of electricity either into the New Zealand Wholesale Electricity Market, or to an electricity retailer for the purpose of supplying retail customers, whether those retail customers are connected to TLC's electricity network or otherwise;
 - Any generation asset to which this exemption relates must not be connected to electricity lines owned or operated by TLC except to the extent that is necessary in order to connect the generation asset to the local distribution network; and
 - This exemption is specific to the cross-involvements created through TLC's involvement in MHL for the purposes of developing the proposed hydro generation plant at Matawai. It does not extend to any other interest or existing or future cross-involvement of TLC.

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?

- 62 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.
- 63 Any of these possibilities of cross-subsidisation could increase upward pressure on lines charges.
- 64 In Decision 576 (Unison Networks Limited) and Decision 591 (Westpower Limited¹¹), the Commission considered that the proposed joint venture ownership structures 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.
- 65 As MHL is currently a wholly owned subsidiary of TLC, there is no joint venture ownership structure to weaken any incentive to cross-subsidise¹². The Commission considers that in order to weaken any incentive to cross-subsidise, it may be appropriate to require an independent director to be appointed to the Board of MHL, though, again, this is not a factor which, on its own, would remove such incentives altogether.
- 66 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. TLC submitted that a key reason for requiring the exemption is to draw upon its existing expertise in small hydro-generation and to protect its investment. The Commission considers that granting a limited exemption from s 17 to allow this to occur, 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 a level that is not material, particularly considering the proposed generation plant would not be located on TLC’s electricity network.
- 67 Nonetheless, the Commission considers that a condition of any exemption granted should be the requirement to observe rules 1 to 6 and 11 to 15 of the Arms Length Rules.
- 68 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

¹¹ Commerce Commission, *Decision 591: Westpower Limited*, 25 October 2006.

¹² The Commission is aware that there may be a potential joint venture partner for the proposed generation plant, albeit one with a small shareholding. At the date of this determination, it is 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.

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 46A allows cross-ownership of lines businesses and new renewable generation (such as is proposed by the Applicant), as long as the corporate separation and arms length provisions are complied with. Any opportunity or incentive to cross-subsidise that may be created by the proposal, would be an effect of cross-ownership that is authorised by s 46A. If TLC invested in generation and complied with the corporate separation and arms length provisions, no exemption would be required¹³, but any risk of cross-subsidisation identified above would still exist.

- 69 The Commission does not consider that granting an exemption would materially affect the incentive or opportunity to cross-subsidise the generation activity proposed by TLC. The Commission notes that incentives to cross-subsidise would be further weakened if TLC had a joint venture partner for the proposed generation plant.

Conclusion on Question 2

- 70 The Commission considers that the granting of a limited 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.
- 71 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 from s 17 (requiring compliance with rules 1 to 6 and 11 to 15 of the Arms Length Rules, and requiring the appointment of an independent director to the Board of MHL) 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?

- 72 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.
- 73 This Application specifically seeks exemption from the necessity to comply with rules 7 to 10 of the Arms Length Rules. In general terms, these relate to the appointment of independent directors and managers.
- 74 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.

¹³ On the assumption that the lines company was not proposing to enter into a fixed-price variable-volume contract with an electricity retailer.

- 75 In this case s 46A(2) of the EIR Act requires, where lines companies seek to invest in new 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.
- 76 TLC has submitted that it wishes to draw upon its existing expertise in small hydro-generation and to protect its investment, as stated above.
- 77 The Commission considers that a limited exemption from s 17 to allow TLC to be involved in the Matawai Scheme, subject to the appointment of an independent director to the Board of MHL, is appropriate in this case whilst requiring TLC to comply with rules 1 to 6 and 11 to 15 of the Arms Length Rules.

Conclusion on Question 3

- 78 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 s 17 in this case is unlikely to have any material adverse effect.

Conclusion in Respect of the Commission's Criteria

- 79 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. 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.
- 80 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 material adverse effect.
- 81 Accordingly, the Commission determines to grant a limited exemption to TLC from s 17 of the EIR Act in respect of the cross-involvements outlined in the Application, subject to the following conditions:
- TLC will ensure that no more than two thirds of the Board of Directors of MHL are directors who are either:
 - a) a manager of TLC;
 - b) an associate of TLC, other than by virtue of being a director of MHL; or
 - c) involved in the business of TLC;
 - MHL and TLC'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;
 - TLC must not be involved either directly or indirectly in the selling of electricity generated by the Matawai Scheme to any customer connected to TLC's electricity network. This does not preclude the selling of electricity either into the New Zealand Wholesale Electricity Market, or to an electricity retailer for the purpose of supplying retail customers, whether those retail customers are connected to TLC's electricity network or otherwise;

- any generation asset to which this exemption relates must not be connected to electricity lines owned or operated by TLC except to the extent that is necessary in order to connect the generation asset to the local distribution network; and
- this exemption is specific to the cross-involvements created through TLC's involvement in MHL for the purposes of developing the proposed hydro generation plant at Matawai. It does not extend to any other interest or existing or future cross-involvement of TLC.

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

THE COMMISSION'S DETERMINATION

83 The Commission determines to grant a limited exemption from section 17 of the EIR Act, subject to the terms and conditions stated in the Notice of Exemption.

Dated this day of October 2007

Donal Curtin
Commissioner

NOTICE OF EXEMPTION

The Commerce Commission (Commission), pursuant to section 81 of the Electricity Industry Reform Act 1998 (the EIR Act), exempts The Lines Company Limited (TLC) from compliance with 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 hydro-generation plant, located on the Waikohu Stream near Gisborne, through TLC's wholly owned subsidiary Matawai Hydro Limited (MHL) outlined in its application for exemption registered by the Commission on 5 March 2007.

The exemption is subject to the following conditions:

1. TLC will ensure that no more than two thirds of the Board of Directors of MHL are directors who are either:
 - a. a manager of TLC;
 - b. an associate of TLC, other than by virtue of being a director of MHL; or
 - c. involved in the business of TLC;
2. MHL and TLC'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. TLC must not be involved either directly or indirectly in the selling of electricity generated by the Matawai Scheme to any customer connected to TLC's electricity network. This does not preclude the selling of electricity either into the New Zealand Wholesale Electricity Market, or to an electricity retailer for the purpose of supplying retail customers, whether those retail customers are connected to TLC's electricity network or otherwise;
4. any generation asset to which this exemption relates must not be connected to electricity lines owned or operated by TLC except to the extent that is necessary in order to connect the generation asset to the local distribution network; and
5. this exemption is specific to the cross-involvements created through TLC's involvement in MHL for the purposes of developing the proposed hydro generation plant at Matawai. It does not extend to any other interest or existing or future cross-involvement of TLC.

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 s 81(5) of the EIR Act.

Dated this day of October 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.