

VERSION FOR PUBLIC DISCLOSURE

**Application for an Exemption pursuant to section 81  
of the Electricity Industry Reform Act 1998**

**Date:** 20 July 2005

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**Application:** Pursuant to section 81 of the Electricity Industry Reform Act 1998 ("Act"), application is hereby made to the Commerce Commission for exemption from the application of the EIR Act as described in this application.

## Introduction

1. Unison Networks Limited ("Unison") is an electricity lines business within the definition set out in section 4 of the EIR Act.
2. Unison has entered into a joint venture with Hydro-Electric Corporation ABN 48 072 377 158 of Tasmania, (trading as Hydro Tasmania ("Hydro Tasmania")) to develop, construct and operate a wind farm to generate electricity in the Hawke's Bay (the "Project").
3. Unison and Hydro Tasmania intend to incorporate a joint venture company to own the assets of and to operate the Project ("JV Co"). JV Co will be an electricity supply business within the definition set out in section 5 of the EIR Act.
4. An exemption is sought to enable Unison to be involved within the meaning of the EIR Act in JV Co.

## Application of the EIR Act

5. Unison is an electricity lines business within section 4 of the EIR Act because its primary business is the conveyance of electricity by line in New Zealand. It owns and operates the local distribution networks in the Hawke's Bay, Rotorua and Taupo regions. Unison also provides management services on a contract basis to Centralines, an electricity lines business based in Waipukurau.
6. JV Co will be an electricity supply business pursuant to section 5 of the EIR Act because it will:
  - (a) sell electricity in New Zealand (section 5(1)(a)(i));
  - (b) generate electricity in New Zealand (section 5(1)(a)(iii)); and
  - (c) own and operate generation assets (section 5(1)(b)).

7. It is also possible that section 5(1)(a)(ii) (relating to trading financial hedges) may apply to JV Co as discussed in paragraph 29 below.

### **Cross Involvements and Exemptions**

8. Section 17 of the EIR Act prohibits Unison (an electricity lines business) from being involved with JV Co (an electricity supply business).
9. Section 46A of the EIR Act states that the ownership separation rules are not breached if a person is generating electricity from new generation using only a new renewable energy resource (section 46A(1)(a)(i)). This exemption only applies so long as the corporate separation and arms length rules are complied with.
10. The proposed generation activities of JV Co fall within the exemption in section 46A(a) for generation of renewables except that Unison and JV Co will not be able to comply with the arms length rules.
11. The restrictive provisions in the arms length rules are of significant concern to Unison in the context of a project of this kind and the risks of such a large financial investment without active control over the Project. Accordingly, Unison is applying for an exemption from the application of section 17 of the EIR Act in relation to the Project.

#### *Involvement by Directors, Employees and Shareholders*

12. It is proposed that Unison will have the power to appoint at least two directors to the Board of JV Co. It is likely that these directors will also be directors or senior management of Unison. It is also likely that some Unison employees will be involved in JV Co. Each director or manager of Unison who is also involved in JV Co is potentially a cross-involved person pursuant to section 17. Furthermore, Unison is 100% owned by the Hawke's Bay Power Consumers' Trust (the "Trust"). The applicant believes that, if Unison is granted an

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exemption pursuant to section 81, the cross-involvement of such individuals and the Trust is to be disregarded pursuant to section 19(1)(h).

13. However the wording of section 19(1)(h) is not entirely clear, and so out of an abundance of caution, Unison seeks either:
- (a) a determination that the cross-involvement of any directors or other individuals involved in both Unison and JV-Co, and the Trust, is to be disregarded pursuant to section 19(1)(h); or
  - (b) a class exemption from the application of section 17 for:
    - (i) any directors and other individuals that are involved in both Unison and JV Co; and
    - (ii) the Trust.

### Background to the Project

14. Hawke's Bay Power Limited (the predecessor of Unison) considered the possibility of establishing a wind farm in the 1990s and had done some very preliminary feasibility studies, including wind testing at potential sites, prior to the introduction of the EIR Act.
15. Following the sale of its supply business to comply with the ownership separation rules introduced in 1998, Unison (then known as Hawke's Bay Network Ltd) focused on operating its lines business and did not actively pursue the potential for a wind farm for a number of years. However, security of supply issues and the increasing need for alternative sources of generation as Maui gas is depleted led to renewed interest in the development of a wind farm. The ratification of the Kyoto protocol created a positive outlook for the energy price path, making wind generation economically feasible. Unison also perceived that despite the public interest in environmentally sound forms of

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energy and the government push on renewables, there was a lack of investment in the wind generation sector to date.

16. As a result of these factors, Unison decided to progress the development of a wind farm and sought out Hydro Tasmania as a potential partner. Unison and Hydro Tasmania have complementary strengths – Unison has local experience and familiarity with the resource consent process and other land issues involved. Unison had also previously negotiated some options over private land which it considered might be suitable for development as a wind farm. Hydro Tasmania is a Hobart-based generation company with extensive experience in wind and other renewable energy generation, including the Woolnorth wind farm in Tasmania (capacity 65MW, completed in 2004), the King Island wind farm and the soon to be completed Cathedral Rocks wind farm. It also has several other wind farm Projects in Australia under development. It brings significant technical expertise to the Project.

17. The Project is a single wind farm and will be operated as such, but in order to maximise generation capacity two separate sites have been selected for location of the turbines as follows:

- (a) Stage 1: An estimated 48MW development in the Maungahururu Ranges (35km north west of Napier) consisting of 16 x up to 3MW turbines; and
- (b) Stage 2: an estimated 72MW development in the Te Waka Ranges, south of SH5, being a further 34 x up to 3MW turbines.<sup>1</sup>

The output from both stages will be injected directly into the national grid via a grid injection point located on land owned by Unison. The 220 kVa system passes directly over this property.

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<sup>1</sup> These estimates of generation capacity are greater than as set out in Unison's resource consent application as Unison has been able to secure additional land and accordingly update its estimates.

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While the two parts of the Project detailed above are referred to as "Stages", it is intended that construction on both Stages will be parallel, with an expected start of September 2006 and both Stages being operational by late-2007. The total cost of the Project is estimated to be between \$200 and \$300 million. The parties have invested considerable sums to date to bring the Project to its current state. The map attached as Appendix 1 illustrates the land on which the wind farm will be situated, and the proposed locations of the turbines.

18. Wind is intended to be the sole source of generation capacity. Electricity will be purchased under a standard retail contract for operational uses, included starting the turbines after a period of inactivity.
19. Further background to the Project is set out in the documents filed in support of Unison's tender under the Crown's second tender round for carbon credits, attached as Appendix 2.
20. Unison and Hydro Tasmania have filed for resource consent for Stage 1 and are expecting to file for resource consent for Stage 2 by the end of August. The consent hearing for Stage 1 will be heard in Hastings on the 8th – 12th of August 2005.

### *Potential Expansion*

21. It is possible that the parties will seek to expand the Project by development of a third stage, to incorporate further turbines on land within approximately five kilometres of the Project. This decision will not be made before this exemption application is considered and the specifics of location and capacity have not been determined. Therefore the potential expansion is not included within the scope of this exemption application.

### *Structure and Operation of JV Co*

22. JV Co will be incorporated in New Zealand as a limited liability company, with an expectation that Unison's share will not exceed 50% and Hydro Tasmania

will own the balance of the shares in JV Co. It is possible that Hydro Tasmania's share will be held in conjunction with another equity partner (which will not be a firm that is currently a participant in the New Zealand electricity market). Incorporation is likely to happen within the next three months.

23. Final decisions on the number of directors, method of appointment and related issues have not yet been made. However, it is envisioned that the Board of JV Co will comprise equal numbers of directors appointed by each of Unison and Hydro Tasmania<sup>2</sup>, plus an independent chair. The chair will have the casting vote. It is likely that Unison and JV Co will have at least two common directors (or directors that are drawn from Unison's senior management). Unison would be happy to provide the Commission with further details once such decisions have been finalised.

24. The joint venture partners have to date largely been focused on the initial issues of securing land, financing and consents and planning construction. The optimum operational management structure is still under consideration. The Project is based on a high capital investment/low operating cost model, and it is anticipated that once the Project is operational, management will comprise only one or two staff. It is possible that these management staff will be provided by Unison employees (probably on a contract basis, although this has not yet been determined). This would provide JV-Co with flexibility and ensure Unison's industry experience is best utilised. Ongoing maintenance of the turbines is likely to be carried out by the turbine manufacturer and Unison may have other on site maintenance roles.

### **Commission's Primary Questions**

25. The Commission has stated that it will consider three primary questions when considering an application for exemption. The applicant has addressed each of these questions in the following paragraphs.

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<sup>2</sup> One of Hydro Tasmania's directors may be appointed by its equity partner, if applicable.

*Question 1: 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?*

26. JV Co will only be active in the generation market. It will not have any impact on the distribution market and its only impact on the retail market will be indirectly as a consequence of expanded competition in the generation market. However, for the purposes of analysis and to be consistent with the Commission's approach, the applicant has analysed the national electricity generation market, the national electricity retail market and the local electricity distribution markets in which Unison operates.

*The National Electricity Generation Market*

27. The capacity of the proposed wind farm is estimated to be between 130MW and 150 MW. This output represents about 1.5% of the national electricity generation market.<sup>3</sup> Thus regardless of any other factors the impact of Unison's involvement in generation will be limited.
28. As a generator, JV Co will be required to sell all electricity it generates to the wholesale electricity market operated pursuant to the Electricity Governance Rules.<sup>4</sup> This rule and the transparent operation of the electricity market limits any potential opportunities to inhibit competition.
29. While JV Co will be selling into the spot market as required by the EGRS, it intends to neutralise its risk by entering into a contract for differences ("CFD") with a counterparty generator or retailer. The intention is for such a CFD to be long term (probably 10 years) at a fixed price or with an inflation factor and/or other adjusting factor such as the amount of any applicable carbon tax. The volume will be variable, equivalent to the total volume generated and sold by

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<sup>3</sup> New Zealand's total generation per annum is approximately 40Twh. See the New Zealand Energy Statistics (December 2004 quarter), published 8 March 2005, available on the Statistics New Zealand website: [www.stats.govt.nz](http://www.stats.govt.nz) under Economy/Products and Services/Information Releases.

<sup>4</sup> Rule 6.1 of Part H of the EGRs.

JV-Co on the spot market (as measured at the relevant grid injection point).<sup>5</sup> The reason for entry into a CFD is to minimise the risk of price volatility. Effectively JV Co will be price-neutral as to the price at which the electricity it generates is sold into the national wholesale market. The combination of a long-term contract and price neutrality means that JV Co will have neither the opportunity nor the incentive to negatively affect competition in the generation market.

#### *Introduction of a New Generator*

30. The introduction of JV Co is a pro-competitive development for the generation market. It represents the introduction of a new player, and specifically one with no involvement in the retailing of electricity. It also represents a significant increase in wind as a source of generation to compete with gas, thermal and hydro-electricity. The greater the number of generators in the market, and the more diverse the sources of generation, the more competitive the generation market will be.

#### *National Electricity Retail Market*

31. As noted above in paragraph 28, JV Co intends to (in substance) sell all the electricity generated from the wind farm under a long-term fixed rate/contract. The wind farm will not sell any electricity at all directly to consumers and it will be neutral as to the retail price of electricity. Therefore there is no opportunity or incentive for Unison to negatively impact on competition in the national electricity retail market.
32. One of the Commission's concerns about cross-involvement appears to arise from the possibility that a lines company could discriminate as regards access terms in favour of a retailer it is involved with. This was discussed in Decision No. 541 where the Commission considered that the fact that Vector would not be in a position to influence the access terms of retailers who compete with the

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<sup>5</sup> Depending how the CFD contract is structured it is possible that JV Co will fall within the definition of "selling electricity hedges" pursuant to section 5(1)(a)(ii) of the EIR Act.

supply business with which it was involved (Wanganui gas) was "*an important consideration*", because:

"competition concerns are more likely to arise in a situation where control over an electricity distribution network would create an advantage, vis-à-vis other electricity retailers, in supplying electricity across that network".<sup>6</sup>

33. The applicant submits that its situation is similar to the Vector situation. The electricity generated by JV Co from the wind farm will not be sold directly to consumers connected to Unison's network, and JV Co will not be involved in the market as a retailer. Therefore there are no "*competing retailers*" to whom Unison might restrict access to its electricity network and in any case, Unison has no incentive to influence access terms for retailers to its network. Furthermore, Unison has a policy of open access to its network.
34. As noted above, JV Co will have to purchase electricity for operational purposes. However this will be via a retail contract on normal commercial terms, and nothing in this arrangement will give JV Co or Unison any ability to affect retail electricity competition.

#### *Local Electricity Distribution Markets*

35. As noted above Unison operates in three regional areas – the Hawke's Bay, Taupo and Rotorua regions.
36. The Project will not be connected to any of Unison's local distribution networks and so there will be no commercial relationship between the lines and generation activities that could provide an incentive or opportunity for it or JV Co to inhibit competition in any local distribution market.
37. The Project will require a feeder line into Transpower's 220kv line (i.e. into the national grid). It has not yet been determined whether Unison or JV Co will own this feeder line. If Unison owns it then JV Co and Unison will have to

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<sup>6</sup> Paragraph 66.

have a contractual arrangement dealing with this. However, as the feeder line is physically removed from Unison's network this will have no impact on the distribution market. The contract will be on normal commercial terms.

***Question 2: 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?***

38. In Decision No. 541 the Commission noted that:

"the potential for cross-subsidisation [of generation activities from lines business involvement] is of particular concern where a generator has potential to connect generation directly to a local distribution network".<sup>7</sup>

39. As the wind farm will be connected directly to the national grid and will not be injecting into the local distribution network, the potential for cross-subsidisation does not exist here. The Project is situated within the geographic area in which Unison's electricity network operates, but co-location within the same geographic region is not relevant if the generation assets will not be connected directly to the local distribution network.

### *The Regulatory Environment*

40. The applicant submits that in considering whether its cross-involvement could give rise to cross-subsidisation or the inhibition of competition, it is necessary to consider the regulatory regime to which electricity lines businesses are now subject. The applicant submits that the introduction and application of a range of measures post-dating the EIR Act substantially reduces the opportunities for lines companies to cross-subsidise or inhibit competition compared with the position at the time that ownership separation was introduced. These measures render reliance on the arms length rules less important.

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<sup>7</sup> Paragraph 74, Decision No. 541.

41. The most significant aspect of the regulatory regime in restricting lines' businesses opportunities for cross-subsidisation is Part 4A of the Commerce Act, and in particular the development of thresholds for the investigation of lines businesses which may ultimately result in the imposition of price control. The thresholds act as a disincentive to cross-subsidisation because if cross-subsidisation from lines to generation were to occur it would make it even more difficult to meet the thresholds. Furthermore, the greater transparency of lines businesses' accounts due to threshold compliance and the information disclosure regime would make any cross-subsidisation relatively easy to identify were it to occur.
42. The establishment and breadth of the functions of the Electricity Commission provides another check on lines businesses' abilities to act in an undesirable or inefficient manner. The Electricity Commission is specifically charged with making recommendations for regulations for electricity governance in order to meet specific objectives, including the minimising of barriers to competition and downward pressure on costs.<sup>8</sup> This provides a specific means of addressing situations that could potentially lessen competition.
43. In addition to the general discouragement provided by the regulatory regime, Unison faces a more specific inhibition on cross-subsidisation due to the involvement of Hydro Tasmania. As JV Co is only partly-owned by Unison it would not make sense to divert financial resources from its own business to one in which it has only a partial financial stake.

***Question 3: Would the Commission permit, by granting an exemption in respect of a business or involvement or interest, a relationship between an electricity lines business and an electricity supply business which is not at arms length?***

44. If the relationship between Unison and JV-Co were at arms length, Unison would fall within the exemption in section 46A for generation from renewable resources. The key driver for the exemption application is that compliance

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<sup>8</sup> Section 172N, Electricity Act 1992.

with the arms length rules would mean that Unison would be unlikely to pursue the Project, due to the risks of such a large financial investment without any active control over that investment.

45. Unison notes that the Commission has acknowledged that compliance with the arms length rules is not always strictly necessary, as:

"in most circumstances where an exemption is required from the ownership separation rules a relationship will be created that will ultimately not be at arms' length."<sup>9</sup>

46. In Decision No. 541 the Commission set out its approach to such cases is to:

"assess[s] 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."

47. The applicant considers that the application of the stated approach to its cross-involvement will demonstrate that in this case compliance with the arms length rules is not strictly necessary. The purpose of the EIR Act will not be compromised by an exemption from the arms length rules, on the basis that the cross-involvement of Unison in JV Co does not provide any incentives or opportunities for cross-subsidisation or inhibition of competition.

48. In the preceding paragraphs Unison has set out the reasons why an exemption will not result in cross-subsidisation or lessening of competition. Unison believes that these factors in themselves are sufficient to justify an exemption. However there are also additional policy reasons why non-compliance with the arms length rules is not necessary, and why granting an exemption in relation to Unison's involvement in the Project is consistent with the purpose of the EIR Act as well as Government policy objectives.

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<sup>9</sup> Decision No 541 para 76.

*Objectives of the EIR Act*

49. The overall purpose of the EIR Act is to ensure "costs and prices ... are subject to sustained downward pressure; and the benefits of efficient electricity pricing flow through to all classes of consumer".<sup>10</sup> There is nothing in the structure or operation of the Project that is likely to interfere with this purpose and the applicant submits that purpose is largely addressed by the regulatory regime detailed in paragraphs 41 and 42 above. To the extent that the Project has any impact on prices, the increase in generation capacity of the Project will contribute to the aim of "downward pressure on costs and prices". Furthermore, the Project is a positive development in the context of the Government's overall policy objectives for electricity.

*Government Policy Objectives*

50. The Government's overall policy objective for electricity is "to ensure that electricity is produced and delivered to all classes of consumers in an efficient, fair, reliable and environmentally sustainable manner".<sup>11</sup>
51. The existence of a non-arms length relationship between Unison and JV Co will not negatively affect any part of this objective. In fact Unison submits that the establishment of a significant wind farm will assist in this objective and will contribute towards the efficient use of an under-utilised resource. While wind is by nature a variable power source, its variability is favourable compared to hydro power and acts as a complementary source to hydro. In addition, recent developments in turbine manufacture have resulted in increasingly efficient conversion rates.<sup>12</sup> It is also one of the most environmentally friendly and sustainable forms of generation.

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<sup>10</sup> Section 2(1).

<sup>11</sup> As reflected in the Government Policy Statement Further Development of New Zealand's Electricity Industry released in December 2000 and reiterated in the recent Government Policy Statement on Electricity Governance, October 2004.

<sup>12</sup> *Wind Energy Integration in New Zealand* prepared by Energy Link and MWH New Zealand for Ministry of Economic Development and Energy Efficiency and Conservation Authority, May 2005, p4.

*Impact of the Project on Wind Generation in New Zealand*

52. New Zealand is currently a large "provider" of wind as a natural resource, but only 168MW, representing a tiny 2.5% of generation capacity, is produced from wind.<sup>13</sup> New Zealand's demand for electricity is increasing by approximately 2% per annum. The Minister of Energy has stated that, in terms of increased demand, new developments providing approximately 150MW of electricity per year are required to keep up with economic and population growth.<sup>14</sup> Accordingly, the Government is keen to facilitate further investment in wind generation, both because of the reduction in other base load fuels (especially gas) and because it is environmentally friendly and will contribute to New Zealand's emission reduction obligations as required by the Kyoto Protocol. According to the recently published paper *Wind Energy Integration in New Zealand*,<sup>15</sup> wind could account for up to a third of New Zealand's future peak electricity demand and the Project would contribute to meeting that demand.
53. Specifically, wind generation in diverse geographic areas is desirable because this puts less pressure on the national electricity grid. Other major wind farm developments are proposed for the Manawatu and Wellington (Makara) regions. The Project is one of only two significant wind farms proposed for the Hawkes Bay region.
54. If the Project goes ahead Unison will earn [ ] tonnes of carbon credits.<sup>16</sup> This will assist New Zealand in reducing its overall emissions as required by the Kyoto Protocol.

*Barriers to Investment in Wind Generation*

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<sup>13</sup> Above n12.

<sup>14</sup> Ministry of Economic Development Infrastructure Stocktake: Infrastructure Audit on Electricity (Chapter 4) and the New Zealand Electricity Outlook: Dry Year Security on Modelling Assumptions (Chapter 4). These documents can be found at [www.med.govt.nz/irdev/econ\\_dev/infrastructure/reports/pwc.audit/index.html](http://www.med.govt.nz/irdev/econ_dev/infrastructure/reports/pwc.audit/index.html) and [www.med.govt.nz/ers/electric/dry-year-risk/2003-2007](http://www.med.govt.nz/ers/electric/dry-year-risk/2003-2007) respectively.

<sup>15</sup> Above n13 p4.

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55. Successful investment in wind generation is likely to require several things – considerable financial resources, experience in wind farm generation, knowledge of the New Zealand electricity environment, familiarity with the physical environment and an ability to obtain resource consents required by the Resource Management Act. Given New Zealand's size, there are few firms likely to meet these criteria.
56. The Ministry of Economic Development recently published a discussion note on "*Facilitating Investment in Generation by Lines Companies*".<sup>17</sup> Its purpose is to "open up a discussion on how lines companies' investment in generation can be further facilitated (short of completely removing current ownership restrictions)". The paper notes that although the cross-ownership restrictions in the EIR Act have been relaxed recently, providing opportunities for lines companies to own some generation and sell the output of that generation, the majority of lines companies are yet to take advantage of these opportunities.
57. From Unison's perspective, the amendments to the EIR Act to encourage lines' companies to invest in generation (and especially renewables) are a step in the right direction but are impracticable if full compliance with the arms length rules is required. In terms of the Project, Unison could not make the considerable financial investment necessary if it is unable to be involved in the operation and management of JV Co. Compliance with the arms length rules would necessitate it being a passive financial investor. This would not be attractive to the Unison board and may also put its financing at risk.
58. The Government has specifically directed the Electricity Commission to seek outcomes including "removing barriers to investment in new generation technologies, renewables and distributed generation".<sup>18</sup> The applicant appreciates that the Commerce Commission is not subject to this specific outcome, but it submits that in the context of an application for exemption this is a factor that the Commission should take into account.

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<sup>17</sup> Resources and Networks branch, Ministry of Economic Development, March 2005.

<sup>18</sup> Paragraph 2(g) GPS on Electricity Governance.

*Impact of Relationship not at Arms-Length*

59. In summary, the fact that the relationship between Unison and JV Co will not be at arms length should not disqualify Unison from obtaining an exemption, given there is little or no risk of cross-subsidisation or inhibition of competition.
  
60. The purpose of the EIR Act is not endangered, and the Project is consistent with Government policy objectives and accordingly an exemption should be granted.

**APPENDIX 1**

1. The attached maps for Stage 1 and Stage 2 illustrate the proposed positioning of the turbines. The relevant properties are identified by the names of the land owners with whom Unison has negotiated rights to develop the wind farms.
  
2. The attached map 3 shows the geographic location of Stages 1 and 2 in the Titiokura and Te Waka ranges.

APPENDIX 2

Attached is Unison's tender for carbon credits in the October 2004 tender round, comprising the following documents:

- (a) *"Projects to Reduce Emissions Programme – Second Tender Round Offering Six Million Kyoto Protocol Emission Units – Information About You and Your Project"* 15 October 2004 (this is the Climate Change Office tender document, as completed by Unison); and
- (b) *"Project to Reduce Emissions – Titiokura Wind Farm Update"* 24 March 2005 (updated information supplied by Unison to the Climate Change Office.

APPENDIX 3

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