

Vector Limited

**APPLICATION FOR EXEMPTION UNDER
SECTION 81 OF THE ELECTRICITY INDUSTRY
REFORM ACT 1998**

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Contents

Date of Application	2
Applicant.....	2
Application	2
Other Parties.....	2
Summary of The Proposal.....	2
Details of the Scheme	3
Governance of NZWL.....	4
Reasons for Management of Vector Being Involved in NZWL	4
Application of the EIR Act.....	5
Draft New Zealand Energy Strategy and Cabinet Paper	12
Objectives of the EIR ACT.....	13
Further Information	14

Date of Application

1. 17 May 2007.

Applicant

2. The applicant is Vector Limited ("**Vector**"). As the Commission is aware, Vector is involved in electricity distribution in the Auckland and Wellington regions. Vector also owns a portfolio of infrastructure assets, including gas transmission and distribution pipelines.
3. Vector is listed on the New Zealand Stock Exchange. Its majority shareholder, with a shareholding of 75.1%, is the Auckland Energy Consumer trust. The balance is held through a public share listing.

Application

4. Pursuant to section 81 of the Electricity Industry Reform Act 1998 ("**EIR Act**"), application is hereby made to the Commerce Commission for an exemption from the application of the EIR Act and, in particular, from Arms Length Rules 7-10 requiring separate management of electricity lines and generation businesses.

Other Parties

5. NZ Windfarms Ltd ("**NZWL**") is an electricity supply business in which Vector has agreed to subscribe for a 19.9902% interest. Reference to NZWL in the context of this application also refers to any wholly owned subsidiary of NZWL.
6. NPBB Pty Limited ("**NPBB**") is a business that NZWL has entered into a joint venture with to develop the Te Rere Hau wind farm. N.P. Power Pty Limited and Babcock and Brown own NPBB.

Summary of The Proposal

7. NZWL is a business established to identify and develop sites suitable for development as wind farms.
8. NZWL has identified a suitable site for development as a wind farm, north of Palmerston North.
9. NZWL has entered into a 50:50 joint venture agreement to develop the site with NPBB for a total cost of approximately \$80 million.
10. However, before NZWL can implement the project, it needs to raise capital. It is intended that NZWL will raise approximately \$75 million by way of an initial public share offering.
11. ABN Amro has agreed to underwrite the initial public offering of shares and Vector has agreed to take on the role of cornerstone shareholder. Vector's presence as cornerstone shareholder is considered desirable for the purposes of attracting investment, as it is a well established public listed company with a substantial asset base, whereas NZWL is a relatively new entrant to the equities market.

12. In order to fulfil its role, Vector has agreed to subscribe for a 19.9902% share in NZWL for approximately \$17.3 million at the time of the initial public offering. The remainder of the shares in NZWL will be purchased by any person who wishes to subscribe. (Current owners of NZWL may subscribe for shares in NZWL as part of the public offer.¹)
13. As part of the consideration for Vector taking on the role of cornerstone shareholder, the Subscription Agreement requiring Vector to purchase the 19.9902% share in NZWL, provides that Vector may appoint up to two directors to the board of NZWL.
14. Vector's management (including its directors) have experience and expertise in the electricity sector and Vector wishes to protect and enhance its investment by appointing its staff and/or directors to the board of NZWL. Vector may also provide management expertise from time to time.
15. Consequently, Vector seeks an exemption from Rules 7-10 of the Arms Length Rules in Clause 2 of Schedule 1 of the EIR Act.
16. Vector wishes to appoint its two nominees to the board of NZWL (being existing directors and/or management of Vector) as soon as possible following the initial public offer.

Details of the Scheme

17. The project that is currently being undertaken is the Te Rere Hau wind farm, a 48.5 MW wind farm situated on the Tauranga Ranges near Palmerston North.
18. The final cost of the project will be approximately \$80 million and, as noted above, is being implemented by way of the 50:50 joint venture agreement between NZWL and NPBB. (NPBB and NZWL will each fund approximately \$40 million of the project.)
19. Resource consent was obtained for the project to proceed in May 2005 and the first 5 out of 97 wind turbines have been constructed and are currently being tested.
20. NZWL has now finalised an agreement with a subsidiary of TrustPower Ltd for access to a transformer so that electricity generated from the wind farm can be injected into the grid.
21. The letter from the Chairman of NZWL, published as part of NZWL's Investment Statement and Prospectus for the public share offer records that:

During its development phase, NZ Windfarms intends to supply electricity unhedged (at spot prices) into the New Zealand wholesale electricity market.

¹ Currently there are just over 10 million shares in NZWL of which 3 million are owned by Windflow Technology Limited, 400,000 by five companies and the balance by 16 named individuals.

Governance of NZWL

22. The governance structure of NZWL will be simple. There will be one class of shares issued and voting rights will be the same for all fully paid ordinary shares. NZWL's constitution will grant it general powers to carry on business.
23. NZWL's Investment Statement and Prospectus sets out how capital raised by the initial public offer will be used and it expressly refers to NZWL's obligation to jointly fund the development of Te Rere Hau wind farm with NPBB.
24. The Subscription Agreement between Vector and NZWL provides that, for as long as Vector holds over 15% of the voting rights in NZWL, it may appoint up to two directors to the board of NZWL. NZWL's Investment Statement and Prospectus lists the five current members of the NZWL board and provides that Vector will add its two appointees to that board.
25. As noted above, the Subscription Agreement requires Vector to purchase a 19.9902% share in NZWL at the time of the public offering. Funding from Vector will come from the general funds of the Vector Group. The Subscription Agreement also contemplates that there may be a second offering of shares to raise a further \$25 million of capital in the future (prior to December 2009).
26. If a second public offering proceeds, Vector will be required to purchase a further \$5 million of shares to maintain its 20% shareholding in NZWL. Before any such obligation would arise, various conditions must be fulfilled, including the offering of shares on substantially the same conditions as the initial public offering and the Te Rere Hau wind farm project being complete.
27. Three important governance issues to note are that:
 - (a) Vector will not have a controlling shareholding in NZWL, as it will only have a 19.9902% share in the voting rights of the company;
 - (b) Vector can only appoint up to two directors to the board of NZWL; and
 - (c) Any operational input into the activities of NZWL by Vector will be carried out on a transparent and contestable basis.

Reasons for Management of Vector Being Involved in NZWL

28. Vector wishes to appoint its management (including directors) to the board of NZWL for the following reasons:
 - (a) As noted above, Vector will be the cornerstone shareholder in NZWL and its presence will give comfort to other investors;
 - (b) Vector personnel have considerable experience in managing complex commercial transactions and issues particular to publicly listed companies;
 - (c) Vector personnel also have considerable operational expertise in relation to managing infrastructure investments, including electrical engineering expertise; and

(d) Vector wishes to protect and enhance its investment in NZWL.

Application of the EIR Act

29. Section 4 of the EIR Act provides that:

- (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.
- (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; ...

30. Vector falls within the above definition and, accordingly, is an electricity lines business.

31. The EIR Act provides for the definition of "electricity supply business" in s5(1):

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.

32. NZWL is or will become an electricity supply business as it will generate and sell electricity in New Zealand and it may or may not currently own "core generation assets".²

33. Section 17 of the EIR Act prohibits an electricity lines business from involvement in an electricity supply business:

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.

34. Section 7 of the EIR Act provides the meaning of "involved":

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.

35. Applying the definition set out above, Vector would potentially be "involved" in an electricity supply business. First, Vector's ownership interest would exceed the 10% threshold. Secondly, if Vector exercises its rights in the Subscription Agreement and appoints its management to the board of NZWL it would be deemed to have "material influence" over the business of NZWL.

36. The meaning of "material influence" provided in section 11 of the EIR Act would also deem a person involved in Vector who sits on the board of NZWL's directors as having a material influence over NZWL:

² It is not clear exactly whether NZWL is currently an electricity supply business because that issue will turn on when "core generation assets" come into existence. As already noted, approximately five wind turbines have been built at the site of the Te Rere Hau wind farm but they are not yet operational and have not been connected to the grid. Accordingly, for the purposes of the EIR Act, it is unclear whether these constitute "core generation assets".

Meaning of "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:

37. "Manager" is defined as follows:

Manager, in relation to a person,—

(a) Means a person who, whether alone or jointly with any other person, manages, or directs or supervises the management of, the whole or a substantial part of the business and affairs of the person; and

(b) Includes, for the avoidance of doubt,—

(i) In relation to a body corporate, a director or officer of that body corporate:

(ii) In relation to a trust, a trustee:

(iii) In relation to a local authority, a councillor;

but

(c) Does not include, in relation to an electricity business in which a local authority or any other person has an interest, a councillor of that local authority or manager of that person only as a result of having that position:

38. However, section 46A of the EIR Act allows cross-ownership to exist in particular circumstances with respect to new generation from new renewable energy sources:

Exemption 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 energy 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).
39. Section 46A of the EIR Act allows Vector to proceed with its involvement in NZWL, provided that sections 24 and 25 of the EIR Act are complied with.
40. Section 24 of the EIR provides:
- Corporate separation**
- Every person that carries on an electricity business that is exempt from complying with the ownership separation rules by reason of any of sections 28 to 35 (interim exemptions) or sections 37 to 45 (mirror trusts) or section 46A (exemption for new distributed generation from new renewable energy source) or section 46C (exemptions for generation commissioned after 20 May 2003 and for reserve energy) must, from 1 April 1999, carry on its electricity lines business and its electricity supply business in different companies.
41. In this instance, corporate separation will be achieved by virtue of the fact that NZWL is a separate business from Vector. Vector would merely be purchasing a

minority shareholding in NZWL and appointing two members of its management or directors to assist with NZWL's governance at board level.

42. Section 25 of the EIR Act provides:

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 any of sections 28 to 35 (interim exemptions) or sections 37 to 45 (mirror trusts) or section 46A (new distributed generation from new renewable energy source) or section 46C (exemptions for generation commissioned after 20 May 2003 and for reserve energy), and every electricity business in which any such person is involved, must, from 1 April 1999, 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.

43. Vector's involvement in NZWL means that it must comply with the Arms Length Rules to avoid breaching the EIR Act.

44. The Arms Length Rules are set out in Schedule 1 of the EIR Act. However, particularly significant are rules 7-10, which require the management of the electricity lines business and the electricity supply business to be separate. Rules 7-10 of the Arms Length Rules are set out below:

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.

45. It is intended that the management (including directors) of Vector will be involved in the board of NZWL for the reasons set out above.
46. Accordingly, Vector seeks an exemption from Rules 7-10 of the arms Length Rues under section 81 of the EIR Act. Section 81 states:

- (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.

47. It should be noted that all parties deemed to be involved in both Vector's electricity lines business and NZWL would be deemed to be cross involved themselves. This extends to the management (including directors) of Vector who, it is proposed, will sit on the board of the electricity supply business.
48. However, if the Commission were to grant an exemption to Vector, any such involvements could be disregarded through the operation of s19(1)(h):

Certain businesses and involvements to be disregarded

- (1) For the purposes of this Act, no account is to be taken of a person's business, or involvement or interest in a business, if—
- ...
- (h) The business, involvement, or interest is exempted by the Commission under s81...

49. Consequently Vector seeks an exemption from the Commerce Commission in respect of rules 7-10 of the Arms Length Rules so that it and its staff may proceed to be on the board of NZWL without breaching the EIR Act.

Analysis In Terms of the Commerce Commission's Criteria

50. In considering applications for an exemption under section 81 of the EIR Act, the Commission has stated that it will consider the following three questions. We address each question in turn.

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?

51. Vector considers the relevant market to be the national electricity wholesale market because the electricity generated will be injected into the national grid.
52. Should the exemption be granted, Vector considers that opportunities or incentives to inhibit competition would be minimal for the following reasons:
- (a) Vector will have a 19.9902% shareholding in NZWL only and only two directors on the NZWL board so it would not have sufficient control over NZWL to use it as a vehicle for inhibiting competition;
 - (b) The exemption sought would remove the requirement for separate management only. The other safeguards provided by the EIR Act would remain in place to constrain any potential for alleged anticompetitive conduct (these include, general duties to take all reasonable steps to run the businesses at arms length, restrictions on the use of information, duties to keep transactions between the electricity supply and electricity lines businesses at arms length and duties to focus on the interests of ultimate owners). Also as required by section 24 of the EIR Act corporate separation will be maintained;
 - (c) The quantity of electricity generated by NZWL would be insufficient to have a material impact on the national wholesale market. NZWL will be a very small market participant in a market where several other major participants; and
 - (d) NZWL will, in fact, be a new player into the electricity wholesale market, which would have a pro-competitive effect.

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?

53. There is minimal risk, if any, of this occurring.
54. There would be no incentives for Vector to cross-subsidise the generation activities of NZWL, as that would result in Vector transferring profits to a business in which it owned a 19.9902% share only.
55. The exemption sought would result in the removal of the requirements relating to separate management only. The remaining safeguards imposed by the EIR Act would remain in place to prevent the risk contemplated from occurring.
56. Both Vector and NZWL are public listed companies. Accordingly, both are under reporting obligations, and related party transactions rules which add an additional level of transparency to their business activities.

57. Subsequent to the introduction of the EIR Act, Vector has become subject to a thresholds regime and an information disclosure regime, both of which are administered by the Commerce Commission under Part 4A of the Commerce Act 1986. The obligations imposed by these regimes substantially reduce the opportunities for Vector to engage in cross-subsidisation because of the transparency that they create in respect of the activities of Vector's electricity lines business.

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?

58. The exemption sought would result in the removal of the requirements in relation to separate management only. The remaining safeguards imposed by the EIR Act would remain in place to prevent the risk contemplated from occurring.
59. The capacity of board members of NZWL appointed by Vector to influence the activities of NZWL will be limited in two key respects:
- (a) Vector will only have a 19.9902% interest in NZWL; and
 - (b) NZWL will be a public listed company in its own respect and so the board will be accountable to the securities market by way of reporting, governance and continuous disclosure obligations.

Draft New Zealand Energy Strategy and Cabinet Paper

60. On 11 December 2006 the Ministry of Economic Development ("**MED**") published its draft New Zealand Energy Strategy entitled *Powering Our Future: Towards a Low Emissions Energy System - Draft New Zealand Energy Strategy to 2050* ("**the NZES**").
61. 3.3.1 of the NZES states, "*Action: Government will relax some of the conditions around investment by lines companies*" the paper then goes on to list a number of potential reforms to the EIR Act. One of the reforms proposed is exempting lines companies investing in generation from almost all of the requirements of the EIR Act (except for accounting separation), where they are investing outside of their networks.
62. The proposal by the NZES builds upon approximately two years of consultation by the MED on potential ways of relaxing the EIR Act and a Cabinet Paper published in November 2006 entitled *Electricity Market Review: Investment In Generation By Lines Companies (Paper Three)* ("**the Cabinet Paper**").
63. Paragraphs 38 -42 of the Cabinet Paper states:
- I recommend that all restrictions on investing in generation and in retailing outside of a lines company area be removed. The reason for this is that, outside their lines region, lines companies do not have the ability to act in an anti-competitive manner, nor do they have privileged information about customers.

I also propose to remove the requirement for lines companies to comply with the arm's -length rules when generation owned by a lines company is connected to a different distribution network or the transmission grid.

There would still be some risk of lines businesses cross-subsidising their investments. However, **this risk is substantially reduced by the Commerce Commission monitoring of the price threshold regime and information disclosure requirements set out in Part 4A of the Commerce Act.** It is recommended that accounting/financial separation between competitive generation and monopoly lines businesses be retained nonetheless to mitigate cross-subsidy risks.

Restrictions on cross-owned supply businesses trading in financial hedges and spot energy will also need to be removed to support the relaxations on generations investments and retailing outside a lines company's region.

A monitoring regime will be needed to ensure cross-owned supply businesses only retail within their lines region the output of any generation owned within that region (that is, connected to local lines). It is recommended that companies be required to provide an audited statement to the Commerce Commission annually confirming that the quantity of the electricity sold over a calendar year to customers connected to their lines does not (on average over the 12 months period) exceed the limit of nominal generation capacity owned by the lines company and connection to its lines.

64. The proposals referred to above provide a useful context when considering Vector's application. It is clear from the NZES and the Cabinet Paper that the Government's current thinking is that there is room for the provisions of the EIR Act to be relaxed, without there being an unacceptable risk to competition, especially where investment is occurring outside of lines businesses' networks.
65. It appears that part of the rationale for the Government taking this approach has been the passing of new legislation to make the activities of electricity lines businesses more accountable and transparent. In particular, the information disclosure regime and the Part 4A thresholds regime would make it much harder for lines companies to cross subsidise or engage in anticompetitive behaviour than was the case in 1998 when the EIR Act was first passed.
66. In light of the proposals referred to above, the exemption sought by Vector are appropriate.

Objectives of the EIR ACT

67. The overall purpose of the EIR Act (In section 2(1) of the EIR Act) is to ensure that "costs and prices ...are subject to sustained downward pressure; and the benefits of efficient electricity pricing flow through to all classes of consumer". There is nothing in the structure or nature of Vector's proposal that is likely to interfere with this purpose. In fact, the emergence of a new supplier of electricity at wholesale will increase competition, and increase the supply of electricity that is not dependant on rainfall and thus potentially lower electricity prices, particularly when there is a threat of a dry year.

Further Information

68. If the Commission requires any further information in relation to this application for exemption please contact either Russell McVeagh or Vector. The relevant contact details are listed below.

69. **Russell McVeagh contact details**

Solicitor acting: Andrew Peterson/Simon Haines
Telephone: (09) 367 8315/(09) 367 8110
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Email: Andrew.peterson@russellmcveagh.com/
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48 Shortland Street
P O Box 8
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70. **Vector Limited contact details**

Contact: Simon Mackenzie
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Email: simon.mackenzie@vector.co.nz
Postal address: Vector Limited
101 Carlton Gore Road
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DECLARATION

THIS APPLICATION is made by **Vector Limited**

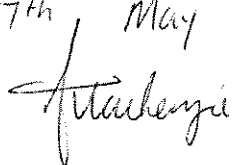
We hereby confirm that:

- (a) all information requested by the Commerce Commission has been supplied;
- (b) all information known to the applicant(s) which is relevant to the consideration of this application has been supplied to the Commerce Commission; and
- (c) all information supplied by the applicant(s) to the Commerce Commission is correct as at the date of this application.

The company undertakes to advise the Commerce Commission immediately of any material change in circumstances relating to the application.

Date: 17th May 2007

Signed by:



Group General Manager

Director/Chief Executive Officer/Other (specify)

I am a ~~Director~~/Officer of the company and am duly authorised to make this application.