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COMMERCE COMMISSION

Decision No. 618

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:

VECTOR LIMITED

The Commission:

D F Curtin
D R Bates

Summary of the Application:

Application by Vector Limited for exemption from rules 7 to 10 of the Arms Length Rules of the Electricity Industry Reform Act 1998, in respect of proposed investment in wind generation.

Determination:

The Commission, pursuant to s 81 of the EIR Act, determines to grant a limited exemption from compliance with s 46A(2) insofar as it requires, via s 25, compliance with rules 7 to 10 of the Arms Length Rules of the EIR Act, on the conditions specified in the Notice of Exemption.

Date of Determination:

26 September 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 17 May 2007 the Commerce Commission (the Commission) registered an application (the Application) from Vector Limited (Vector) for exemption from rules 7 to 10 of the Arms Length Rules¹ of the Electricity Industry Reform Act 1998 (the EIR Act).
- 2 Vector is an electricity lines business whose networks are located in the Auckland and Wellington regions. Vector is listed on the New Zealand Stock Exchange and is 75.1% owned by the Auckland Energy Consumer Trust, with the balance of shares held through a public share listing.
- 3 Vector is proposing to purchase a 19.9902% interest in NZ WindFarms Limited (NZWL). NZWL, through its wholly owned subsidiary, NZWL-TRH Limited, has entered into a 50:50 joint venture with NPBB Pty Limited (NPBB) to develop the Te Rere Hau wind farm, north of Palmerston North. This will be the first of a portfolio of wind farms that NZWL plans to own and operate throughout New Zealand
- 4 The Te Rere Hau wind farm is not on Vector's local distribution network, rather, the generation will be connected to the national grid via a transformer owned by a subsidiary of TrustPower Limited (TrustPower).
- 5 Vector 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 EIR 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 regional electricity distribution markets, granting a limited exemption in this case would not create incentives or opportunities for Vector to inhibit competition.

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.

- 9 Further, the Commission considers that a limited exemption would not create an incentive or opportunity to inhibit competition in respect of the electricity retail markets, as neither Vector, NZWL (or its subsidiary NZWL-TRH Limited) nor Te Rere Hau Joint Venture will be involved in electricity retailing as a result of the proposal.

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

- 10 The Commission considers that granting a limited exemption from compliance with rules 7 to 10 of the Arms Length Rules, 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 compliance with rules 7 to 10 of the Arms Length Rules (but still requiring compliance with rules 1 to 6 and 11 of the 15 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 Vector'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 compliance with rules 7 to 10 of the Arms Length Rules 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 compliance with s 46A(2) insofar as it requires, via s 25, compliance with rules 7 to 10 of the Arms Length Rules, in respect of the cross involvements outlined in the Application that relate to the Te Rere Hau wind farm located north of Palmerston North, subject to the following terms and conditions:
- Vector must not be involved either directly or indirectly in the selling of electricity generated by the Te Rere Hau wind farm to any customer connected to Vector'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 Vector's electricity network or otherwise;
 - Any generation asset to which this exemption relates must not be connected to electricity lines owned or operated by Vector except to the extent that is necessary in order to connect the generation asset to the national transmission network; and
 - The exemption is specific to the cross-involvements created through Vector's involvement in NZWL, NZWL-TRH Limited and Te Rere Hau Joint Venture for the purposes of developing the Te Rere Hau wind farm. It does not extend to any other interest, or existing or future cross-involvement of Vector.

INTRODUCTION

- 1 On 17 May 2007 the Commerce Commission (the Commission) registered an application (the Application) from Vector Limited (Vector) for exemption from rules 7 to 10 of the Arms Length Rules of the Electricity Industry Reform Act 1998 (the EIR Act).

COMMISSION PROCEDURES

General

- 2 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 D R Bates QC and D F Curtin, Commission members.

Criteria Used by the Commission to Consider Exemption Applications

- 3 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
- 4 The Commission stated in Practice Note No.3 that:

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

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

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

- (a) costs and prices in the electricity industry are subject to sustained downward pressure; and
- (b) the benefits of efficient electricity pricing flow through to all classes of consumers by –
 - (c) effectively separating electricity distribution from generation and retail; and
 - (d) promoting effective competition in electricity generation and retail.

- 5 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:

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

- 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.

- 6 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

Vector Limited (Vector)

- 7 Vector is an electricity lines business whose networks are located in the Auckland and Wellington regions. Vector also owns a portfolio of infrastructure assets, including gas transmission and distribution pipelines.
- 8 Vector is listed on the New Zealand Stock Exchange and is 75.1% owned by the Auckland Energy Consumer Trust, with the balance of shares held through a public share listing.

Other Parties

NZ WindFarms Limited (NZWL)

- 9 NZWL is an electricity supply business, which has entered into a 50:50 unincorporated joint venture with NPBB Pty Limited (NPBB) to develop the Te Rere Hau wind farm near Palmerston North. NZWL holds its interest in the Te Rere Hau Joint Venture through its wholly owned subsidiary, NZWL-TRH Limited. These relationships are diagrammatically represented in Appendix 2.
- 10 NZWL's core business activities are the identification, development, operation and ownership of wind farms throughout New Zealand and in other markets where wind power is economic. NZWL proposes to develop a geographically diverse portfolio of renewable generation that will be owned either wholly by NZWL or in partnership with others. NZWL may also explore other forms of generation from renewable resources in the medium to long term.
- 11 NZWL is listed on the New Zealand Stock Exchange.

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.

NPBB Pty Limited (NPBB)

- 12 NPBB has entered into a 50:50 unincorporated joint venture with NZWL to develop the Te Rere Hau wind farm near Palmerston North.
- 13 NPBB is owned by Babcock and Brown Windpower (a wholly owned subsidiary of Babcock and Brown Limited, a global investment and advisory firm) and N.P. Power (the Australian arm of National Power, a specialist in renewable energy).

THE PROPOSAL

- 14 The Te Rere Hau wind farm currently has generation capacity of 2.5 MW but, when complete, will have generation capacity of 48.5 MW, comprising 97 turbines, with an estimated annual output of 160 GWh of electricity.
- 15 The wind farm will not be directly connected to Vector's distribution network, rather the Te Rere Hau wind farm will be connected to TrustPower Limited's grid injection point near the Tararua wind farm, approximately four kilometres to the north.
- 16 Currently, all electricity that is generated by Te Rere Hau wind farm is sold by the Te Rere Hau Joint Venture in the wholesale electricity market at the spot price. The Te Rere Hau Joint Venture plans to continue to sell electricity on the wholesale market at the spot price, until such time as the cost of carbon is included in the electricity price, and then it will consider how it can manage its risks relating to the price of electricity. The Te Rere Hau Joint Venture has no plans to enter the retail electricity market at present.
- 17 Vector has agreed to subscribe for a 19.9902% share in NZWL and is proposing to appoint two directors to the board of NZWL.
- 18 Vector has applied, under s 81 of the EIR Act, for exemption 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 protect and enhance its investment by appointing its staff and/or directors to the board of NZWL, and by providing management expertise from time to time.
- 19 Vector's application for exemption from rules 7 to 10 of the Arms Length Rules, is in respect of its involvement in Te Rere Hau wind farm, and any future involvement in new renewable generation plant that may arise as a result of Vector's investment in NZWL.

APPLICATION OF THE ACT

Electricity Lines Business Involvements

- 20 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.
- 21 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.

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

Electricity Supply Business Involvements

23 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.

24 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 the nameplate or nameplates) and 2% of the maximum demand, in the immediately preceding financial year, of the system to which the distributed generation is connected; and
 - (ii) the distributed generation is owned or operated by a business that also conveys electricity by line and that distributed generation is connected to those lines:
- (f) Selling financial transmission rights that hedge risks arising from the effects of losses and constraints on the national grid:
 - (g) Owning or operating, directly or indirectly, a generator referred to in any of the paragraphs (b) to (f) or subsection (3) or any other core generation assets used in connection with those generators.
- 25 In its application, Vector submitted that NZWL (including NZWL-TRH Limited) 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" (the Commission notes that these assets are now operational).
- 26 The Commission considers that Te Rere Hau Joint Venture is an electricity supply business by way of ss 5(1)(a)(i) and (iii), and also by way of s 5(1)(b).
- 27 The Commission considers that NZWL (and its subsidiary NZWL-TRH Limited) is an electricity supply business by way of s 5(1)(b).
- 28 Vector further submitted that Vector would be "involved" in an electricity supply business for several reasons. First, Vector's ownership interest in NZWL would exceed the 10% threshold (s 7(1)(b)). 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 (s 7(1)(c)).
- 29 Vector considers that the definition of "material influence" provided in s 11 of the EIR Act deems a person involved in Vector who sits on the board of NZWL to have material influence over NZWL.
- 30 The Commission agrees with Vector's submissions and considers that the proposal would result in Vector being an electricity supply business by way of s 5(1)(b) and would also result in Vector being involved in the electricity supply business, NZWL (and its subsidiary NZWL-TRH Limited), by way of ss 7(1)(b) and (c).
- 31 Vector also submitted that, in addition to appointing two directors to the board of NZWL, it intends to provide management expertise from time to time. The Commission considers that this may result in Vector being involved in the electricity supply business, Te Rere Hau Joint Venture, by way of s 7(1)(c).

Cross-Ownership Prohibition

- 32 One of the key intentions of the 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 generation from new renewable energy source

33 The EIR Act was amended in 2001⁴ with the intention of relaxing the principle of ownership separation to allow for cross-ownership to exist in particular circumstances with respect to generation from 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. Exemption for new...generation from new renewable energy source

- (1) The following activities do not cause any person to be in breach of 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 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 the 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 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 any 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).

34 Te Rere Hau Joint Venture is developing the Te Rere Hau wind farm, which is deemed to be generation from a renewable energy source through s 46A(4)(a). Accordingly, Vector is deemed not to be in breach of the cross-ownership provisions (subject to s 46A(2)) in so far as the proposal relates to:

- the generation of electricity by the Te Rere Hau wind farm;
- the selling of that electricity; and
- the ownership or operation of the related generation assets.

⁴ Section 46A was further amended, as from May 2003, by omitting the word “distributed” wherever it appeared.

35 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.

Corporate Separation and Arms Length Rules

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

24. Corporate separation–

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

37 Section 25 refers to the requirement to comply with the arms length rules:

25. Arms length rules –

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

38 Schedule 1 of the EIR Act sets out in details 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

39 Section 7(1) of the EIR Act provides for the definition of “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.

40 Section 11 of the EIR Act provides for the definition 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:
 - (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.

41 The Commission considers that all parties deemed to be involved in both Vector's electricity lines business and Vector'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 staff and/or directors of Vector which, it is proposed, will sit on the board of the electricity supply business NZWL.

42 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...

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

The Commission's Exemption Power

44 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

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

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

- 46 Therefore, Vector has sought an exemption from rules 7 to 10 of the Arms Length Rules, requiring separate management of electricity lines and generation businesses, to enable it to operate its electricity lines business and manage its investment in NZWL in a manner that is other than at arms length.

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

- 47 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.
- 48 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.3⁵ 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

- 49 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 markets that correspond with Vector's electricity distribution networks.

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?

- 50 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.
- 51 The relevant markets⁶ for the consideration of this application are:
- the regional electricity distribution markets in the Auckland and Wellington regions (geographically defined by the boundary of the Vector distribution networks in those areas);⁷ and
 - the national electricity generation and wholesaling market.⁸
- 52 The Commission considers that, in the case of the Te Rere Hau wind farm, as neither Vector, NZWL (or its subsidiary NZWL-TRH Limited) nor Te Rere Hau Joint Venture

⁵ Commerce Commission, *Practice Note No.3: Electricity Industry Reform Act 1998 Commission's Role and Processes*, September 1998

⁶ 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.

⁷ 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.

⁸ 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.

will be involved in the selling of electricity to anyone connected to Vector's electricity distribution network, analysis of either the national or a regional electricity retailing market is unnecessary.

Regional Electricity Distribution Markets

- 53 The regional distribution markets that are relevant to the Application are the Auckland and Wellington regions, being the regions where Vector is the network operator.
- 54 Local 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.
- 55 Accordingly, the granting of a limited exemption would not, in respect of this market, create incentives or opportunities to inhibit competition.

National Electricity Generation and Wholesaling Market

- 56 Vector submitted that, in the case of the Te Rere Hau wind farm, the quantity of electricity generated would be insufficient to have a material impact on the national wholesale electricity market. The Te Rere Hau wind farm will have a generating capacity of 48.5 MW, which equates to 0.7% of the peak demand in the wholesale electricity market.
- 57 Vector also submitted that the Te Rere Hau wind farm will be a new (albeit very small) participant in this market which will have a pro-competitive effect.
- 58 Te Rere Hau Joint Venture is planning to connect the Te Rere Hau wind farm to the national transmission network at the Tararua grid injection point and sell the electricity it generates on the wholesale electricity market.
- 59 In Decision 576⁹ 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.
- 60 Similarly to the situation in Decision 576, Vector does not intend to connect the generation from Te Rere Hau wind farm to its local distribution network, nor sell the electricity generated to end-use customers.
- 61 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 that the capacity of the Te Rere Hau wind farm will comprise only 0.7% of the wholesale market.
- 62 Accordingly, the Commission considers that the connection of the Te Rere Hau wind farm to the national grid, and the sale of the electricity generated through the wholesale electricity market, will not create incentives or opportunities for Vector to inhibit competition in the national generation and wholesaling market.

⁹ Commerce Commission, *Decision 576: Unison Networks Limited*, 15 March 2006.

- 63 However, at this stage, the Commission cannot be certain that any future generation projects undertaken by NZWL would be sufficiently similar to the Te Rere Hau wind farm project to enable the Commission to grant an open-ended exemption.

Conclusion on Question 1

- 64 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 markets where Vector is the network operator, the granting of a limited exemption in this case would not create incentives or opportunities for Vector to inhibit competition.
- 65 The Commission considers that it is appropriate to make any exemption granted in this case conditional on the following:
- Vector must not be involved either directly or indirectly in the selling of electricity generated by the Te Rere Hau wind farm to any customer connected to Vector'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 Vector's electricity network or otherwise;
 - Any generation asset to which this exemption relates must not be connected to electricity lines owned or operated by Vector except to the extent that is necessary in order to connect the generation asset to the national transmission network; and
 - The exemption is specific to the cross-involvements created through Vector's involvement in NZWL, NZWL-TRH Limited and Te Rere Hau Joint Venture for the purposes of developing the Te Rere Hau wind farm. It does not extend to any other interest, or existing or future cross-involvement of Vector.

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?

- 66 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.
- 67 Any of these possibilities of cross-subsidisation could increase upward pressure on lines charges.
- 68 In Decision 576 (Unison Networks Limited) and Decision 591 (Westpower Limited¹⁰) the Commission considered that the proposed joint venture ownership structures would weaken the incentive to cross-subsidise, though this is 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

¹⁰ Commerce Commission, *Decision 591: Westpower Limited*, 25 October 2006.

generation business. It is possible that an incentive to cross-subsidise would arise from a wish to make the regulatory regime for lines businesses less effective by ‘hiding’ lines profits in the generation business.

- 69 Vector will only have a 19.9902% share of NZWL and proposes to have two out of seven directors on the board of NZWL. In addition, NZWL’s subsidiary, NZWL-TRH Limited, will only hold a 50 percent interest in Te Rere Hau Joint Venture. Similarly to the Unison and Westpower cases, the Commission considers that these factors would weaken the incentive to cross-subsidise, though, again, this is not a factor which, on its own, would remove such incentives altogether. NZWL has indicated that there is a possibility that the total number of directors may reduce to six, giving Vector two out of six directors on the NZWL board. However, the Commission does not consider that this would have a material effect on any incentives or opportunities to cross-subsidise.
- 70 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. Vector submitted that a key reason for requiring the exemption is to enable it to appoint its staff and/or directors to the board of NZWL, enabling it to protect and enhance its investment. The Commission considers that granting a limited exemption from compliance with rules 7 to 10 of the Arms Length Rules to allow this to occur, whilst retaining the obligation to comply with the balance of the Arms Length Rules, is appropriate. The Commission considers that this would limit the extent to which incentives or opportunities (to mis-allocate costs) would be increased by the exemption, to a level that is not material.
- 71 Further, the Commission has considered the extent to which an exemption might enable a direct financial cross-subsidisation between the lines business and generation business, or whether such a relationship would enable the lines business to incur risk that would be more properly incurred by the generation business. The Commission considers that these opportunities and incentives, to the extent that they exist at present, would not be created by the Commission granting a limited exemption in this instance. Section 46A allows cross-ownership of lines businesses and renewable generation (such as is proposed by the Applicant), as long as the 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 Vector invested in generation and complied with the corporate separation and arms length provisions, no exemption would be required, but any risk of cross-subsidisation identified above would still exist.
- 72 In addition, Vector and NZWL are both listed on the New Zealand Stock Exchange (NZX) and must comply with the NZX listing rules. The Commission considers this would provide increased transparency to all Vector’s and NZWL’s business dealings, and further reduces any risk of cross-subsidisation.
- 73 The Commission does not consider that granting a limited exemption would materially affect the incentive or opportunity to cross-subsidise the generation activity proposed by Vector.

Conclusion on Question 2

- 74 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.
- 75 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 compliance with s 46A(2) insofar as it requires, via compliance with s 25, compliance with rules 7 to 10 of the Arms Length Rules, 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?

- 76 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.
- 77 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.
- 78 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.
- 79 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.
- 80 Vector has submitted that it wishes to appoint directors to the board of NZWL to enable it to protect and enhance its investment, as stated above.
- 81 The Commission considers that a limited exemption to allow Vector to appoint two directors to the board of NZWL (and, potentially, its subsidiary NZWL-TRH Limited) is appropriate in this case whilst maintaining the existing requirement to otherwise comply with the Arms Length Rules.

Conclusion on Question 3

- 82 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 s 46A(2) insofar as it requires, via compliance with s 25, compliance with rules 7 to 10 of the Arms Length Rules in this case is unlikely to have any material adverse effect.

Conclusion in Respect of the Commission's Criteria

- 83 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.
- 84 The Commission also considers that limiting the exemption to rules 7 to 10 of the Arms Length Rules only would not result in any material increase in the opportunities or incentives to cross subsidise generation activities from lines activities.

- 85 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.
- 86 Accordingly, the Commission determines to grant a limited exemption to Vector from compliance with s 46A(2) insofar as it requires, via s 25, compliance with rules 7 to 10 of the Arms Length Rules of the EIR Act, in respect of the cross-involvements outlined in its Application that relate to developing the Te Rere Hau wind farm, subject to the following conditions:
- Vector must not be involved either directly or indirectly in the selling of electricity generated by the Te Rere Hau wind farm to any customer connected to Vector'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 Vector's electricity network or otherwise;
 - Any generation asset to which this exemption relates must not be connected to electricity lines owned or operated by Vector except to the extent that is necessary in order to connect the generation asset to the national transmission network; and
 - The exemption is specific to the cross-involvements created through Vector's involvement in NZWL, NZWL-TRH Limited and Te Rere Hau Joint Venture for the purposes of developing the Te Rere Hau wind farm. It does not extend to any other interest, or existing or future cross-involvement of Vector.

THE COMMISSION'S DETERMINATION

87 The Commission determines to grant a limited exemption from compliance with s 46A(2) insofar as it requires, via s 25, compliance with rules 7 to 10 of the Arms Length Rules, subject to the terms and conditions stated in the Notice of Exemption.

Dated this 26th day of September 2007

Donal Curtin
Commission member
Commerce Commission

NOTICE OF EXEMPTION

The Commerce Commission (Commission), pursuant to section 81 of the Electricity Industry Reform Act 1998 (the EIR Act), exempts Vector Limited from compliance with s 46A(2) insofar as it requires, via s 25, compliance with rules 7 to 10 of the Arms Length Rules of the EIR Act, in respect of the cross-involvements (as that term is defined in the EIR Act) outlined in its Application that relate to the Te Rere Hau wind farm located north of Palmerston North, through Vector Limited's investment in New Zealand WindFarms Limited,.

The exemption is subject to the following conditions:

1. Vector must not be involved either directly or indirectly in the selling of electricity generated by the Te Rere Hau wind farm to any customer connected to Vector'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 Vector's electricity network or otherwise;
2. Any generation asset to which this exemption relates must not be connected to electricity lines owned or operated by Vector except to the extent that is necessary in order to connect the generation asset to the national transmission network; and
3. The exemption is specific to the cross-involvements created through Vector's involvement in NZWL, NZWL-TRH Limited and Te Rere Hau Joint Venture for the purposes of developing the Te Rere Hau wind farm. It does not extend to any other interest, or existing or future cross-involvement of Vector.

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 26th day of September 2007

Donal Curtin
Commission member
Commerce Commission

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.

APPENDIX 2**Ownership Structure for Te Rere Hau Unincorporated Joint Venture**