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

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Pursuant to section 81 of the Electricity Industry Reform Act 1998 (*EIR Act*), application is hereby made to the Commerce Commission for exemption from the application of the EIR Act.

1 EXECUTIVE SUMMARY

Introduction

- 1.1 As the Commerce Commission will be aware from media reports, The Australian Gas Light Company Limited (*AGL*), as part of its ongoing portfolio management, has been exploring alternative options for its 66.05% investment in NGC Holdings Limited (*NGC Holdings*) which it holds through AGL NZ Limited (64.25%) and AGL NZ Investments Pty Limited (1.8%).
- 1.2 AGL has entered into a conditional agreement with Vector Limited for the sale of its investment in NGC Holdings. The agreement is conditional (amongst other things) on Vector receiving an exemption from the application of sections 17 and 18 of the Electricity Industry Reform Act 1998 (*EIR Act*).
- 1.3 Accordingly, pursuant to section 81 of the EIR Act, application is made for exemption from the application of sections 17 and 18 of the EIR Act.
- 1.4 A concurrent application is being made to the Commerce Commission for a clearance pursuant to section 66(1) of the Commerce Act 1986.
- 1.5 In this application:
 - reference to “the merged group” means the group of companies, however structured, that would result if Vector were to acquire AGL’s interest in NGC Holdings (and any further shares in NGC Holdings); and
 - reference to “NGC” means the relevant subsidiary of NGC Holdings.

EIR Act Exemption

- 1.6 Exemption from the application of the EIR Act is sought in relation to the cross involvement in an electricity lines business and an electricity supply business that would be brought about by any acquisition by Vector Limited (or an interconnected body corporate) of AGL’s interest in NGC Holdings and any further acquisition of shares in NGC Holdings.
- 1.7 Vector is an electricity lines business pursuant to section 4 of the EIR Act. By virtue of its interest in the Kapuni Energy Joint Venture (*KEJV*), and operation of the Kapuni Co-generation Plant (the *Cogen Plant*), NGC is involved in an electricity supply business.
- 1.8 None of the exceptions in the EIR Act that allow electricity lines companies to be involved with electricity generation apply in this instance, although aspects of several of the exceptions are applicable.

- 1.9 The applicant considers that there are sound reasons for the Commission granting the exemption sought. In summary, those reasons are as follows:
- (a) Concerns addressed by the EIR Act regime requiring ownership separation between electricity distribution and generation are now addressed by new regulatory regimes, in particular the regulatory regime for lines businesses in Part 4A of the Commerce Act and other existing and proposed regulatory measures available to the Commerce Commission and the Electricity Commission.
 - (b) The proposed amendments to the EIR Act to permit distributors to invest in generation equivalent to 20% of annual loads or 50MW (whichever is the larger) and to invest in unlimited renewable generation indicate the Government considers that electricity lines companies have an important role in generation. These amendments also suggest that the policy rationale for not allowing lines businesses to invest in any type of generation (renewable or otherwise) is weak.
 - (c) The achievement of outcomes in the Government's Policy Statement on electricity will be unaffected by the cross involvement.
 - (d) Vector understands that electricity supply to the Kapuni Gas Treatment Plant (*KGTP*) is incidental to the production of steam from the Cogen Plant. Electricity for the KGTP could be purchased from a local electricity retailer, although Vector understands that NGC would have to spend a significant amount of money connecting to the local network.
 - (e) Vector also understands that the actual amount of electricity that is available to NGC for NGC's own use at the KGTP is a relatively minor proportion of the output of the Cogen Plant and all surplus electricity is sold to Bay of Plenty Electricity Limited (*BOPE*).
 - (f) The output from the KEJV is negligible in terms of the national electricity generation market. It makes up less than 0.5% of that market.
 - (g) Vector understands that the KEJV is managed by a Management Committee comprising representatives of each of NGC and BOPE. It is likely that, in practice, this will mean that no management or control decisions can be made without a unanimous decision of the Management Committee.
 - (h) Granting an exemption will create no incentives or opportunities to inhibit competition in the electricity industry.

- (i) Granting an exemption will create no incentives or opportunities to cross-subsidise the KEJV generation activities from the Vector electricity lines business.]

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2 **CONFIDENTIALITY**

- 2.1 Confidentiality is sought for the information that has been deleted in the "Public Copy" of this application until the applicant confirms in writing to the Commission that the particular information is no longer confidential. The confidential information is contained in paragraphs 1.11 and 1.12.
- 2.2 As provided in section 58 of the EIR Act, confidentiality is sought pursuant to section 100 of the Commerce Act 1986 and pursuant to section 9(2)(b) of the Official Information Act 1982 on the grounds that:
 - (a) the information is commercially sensitive and contains valuable information which is confidential to Vector; and
 - (b) disclosure of it is likely to give an unfair advantage to competitors and unreasonably prejudice Vector's commercial position.

- 2.3 Vector also requests that it be notified of any request made to the Commission under the Official Information Act for the confidential information, and that the Commission seek Vector's views as to whether the information remains confidential and commercially sensitive at the time those requests are being considered.

3 VECTOR AND NGC BUSINESS ACTIVITIES

- 3.1 Vector Limited is the parent company of the Vector Group (*Vector*). A diagram showing the corporate structure of the Vector Group, and a list of the Vector Group companies is set out in Appendix A.
- 3.2 Vector owns and manages network infrastructure in New Zealand with a portfolio of businesses and services including distribution of electricity in the Auckland and Wellington area; distribution of natural gas in the Auckland area; and a telecommunications networks in the Auckland and Wellington CBDs and in other parts of Vector's electricity network area.
- 3.3 For EIR Act purposes, Vector is an electricity lines business.
- 3.4 NGC Holdings is the parent company of the NGC group. A diagram showing the corporate structure of the NGC group, and a list of the companies comprising the NGC group, is set out in Appendix B.
- 3.5 The NGC group is one of New Zealand's major energy infrastructure and services companies, with interests in natural gas transportation, natural gas wholesale and energy metering. NGC's core business comprises:
- **Energy Sales:** NGC's Energy Sales business is involved in the acquisition, processing and sale of natural gas and associated by-products, including LPG. NGC has long term entitlements to gas from the Maui, Kapuni, Pohokura, Surrey and Kahili gas fields and retails that gas to a number of gas retailers, independent power producers, its own industrial retail business and other internal users.
 - **Natural Gas Treatment:** NGC owns and operates gas treatment, processing and conditioning facilities at the Kapuni Gas Treatment Plant (*KGTP*) in Taranaki, and sells LPG, natural gas and carbon dioxide produced at this plant. NGC also has a 50% interest in the joint venture which owns the Cogen Plant which is located within the KGTP and supplies steam and electricity to the KGTP and to the nearby milk factory of The Lactose Company of New Zealand Limited (*Lactose*), with surplus electricity being sold to BOPE.
 - **LPG retailing:** Through the KGTP, its interest in Liquigas Limited (60.25%) and its On Gas retailing business, including bulk and

cylinder sales and sales at BP Service Stations in New Zealand, NGC is involved in the sale and tolling of approximately 190,000 tonnes of gas liquids per annum.

- **Natural Gas Transportation:** NGC owns, operates and manages around 2,500 km of high pressure gas transmission pipeline and associated equipment in the North Island of New Zealand, supplying most major cities and large towns, as well as petroleum product pipelines owned by other companies. NGC also owns and operates more than 2,800 km of intermediate, medium and low pressure gas distribution pipeline networks connected to the high pressure transmission system, located in over 30 towns and cities in the North Island.
- **Energy Metering Services:** NGC is an independent (from energy retailer and network owners) energy metering services provider. The business is predominantly in New Zealand, but recent initiatives have provided the opportunity to expand into Australia. NGC provides both energy meter assets and information services, primarily to energy retailers. NGC owns about 55,000 gas meters and owns electricity meters and related equipment at approximately 800,000 homes and businesses throughout New Zealand.

3.6 By virtue of its interest in, and operation of, the Cogen Plant, NGC is involved in an electricity supply business.

3.7 An exemption is sought pursuant to section 81 of the EIR Act for the potential cross-involvement of the merged group in both an electricity supply business and an electricity lines business as set out in this application.

4 **INVOLVEMENTS PURSUANT TO THE EIR ACT**

Electricity Lines Business

Summary of Vector's involvement in an electricity lines business

4.1 Vector owns and operates electricity distribution networks in the greater Auckland area and in Wellington.

4.2 Vector has over 642,000 end-consumers connected to its electricity networks, which have a total length of 24,639 kilometres.

4.3 Vector is an electricity lines business pursuant to section 4 of the EIR Act because it:

- (a) conveys electricity by line in New Zealand (section 4(1)(a));

- (b) owns and operates lines and other core assets of an electricity lines business in New Zealand (section 4(1)(b)); and
- (c) is not exempted from being an electricity lines business under any of the exemptions set out in section 4(2) of the EIR Act.

4.4 Vector is “involved” in an electricity lines business pursuant to section 7 of the EIR Act because it:

- (a) carries on that business (section 7(1)(a));
- (b) exceeds the 10% threshold (as defined in section 8 of the EIR Act) in respect of that business (section 7(1)(b));
- (c) has material influence over the business (section 7(1)(c)); and
- (d) owns and operates the core assets comprising the business (section 7(3)).

Electricity Supply Business

Summary of NGC’s involvement in an electricity supply business

4.5 NGC is involved in two electricity supply businesses pursuant to the EIR Act by virtue of:

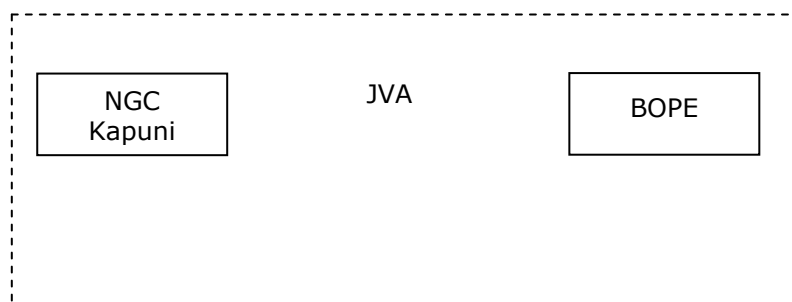
- (a) its 50% participating interest in the KEJV which owns the Cogen Plant located at the KGTP; and
- (b) the operation of the Cogen Plant by NGC New Zealand Limited (*NGC NZ*) on behalf of the KEJV.

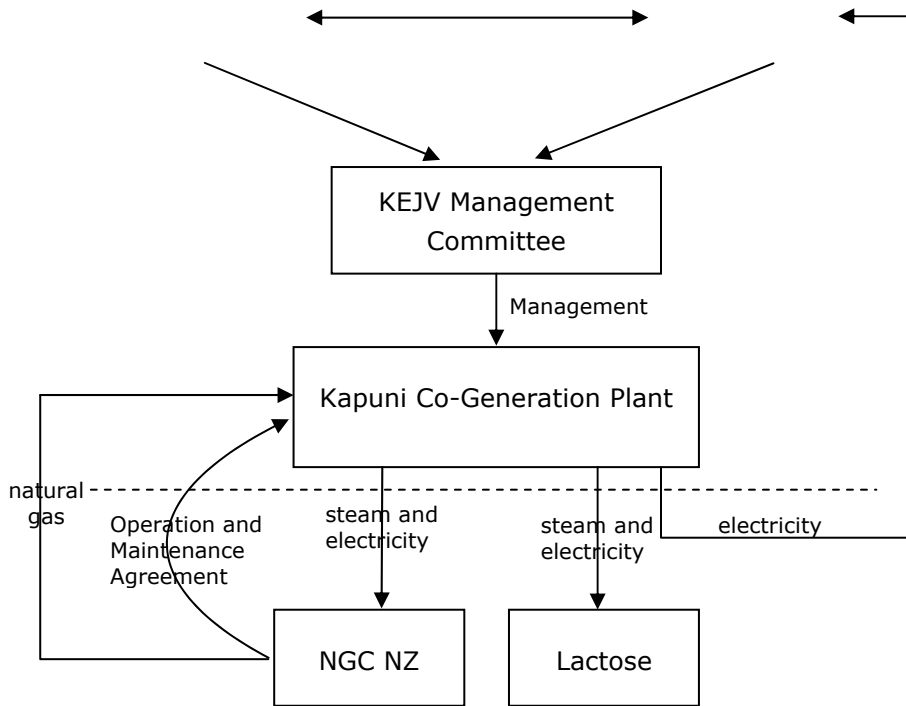
Description of the KEJV

4.6 The KEJV is an unincorporated joint venture between NGC Kapuni Limited (*NGC Kapuni*) and BOPE established under a joint venture agreement dated 26 March 1997. BOPE is a subsidiary of Todd Energy Limited. Both NGC Kapuni and BOPE have a 50% participating interest in the KEJV pursuant to the joint venture agreement.

4.7 The diagram below summarises the key commercial and contractual relationships of the KEJV that Vector is aware of.

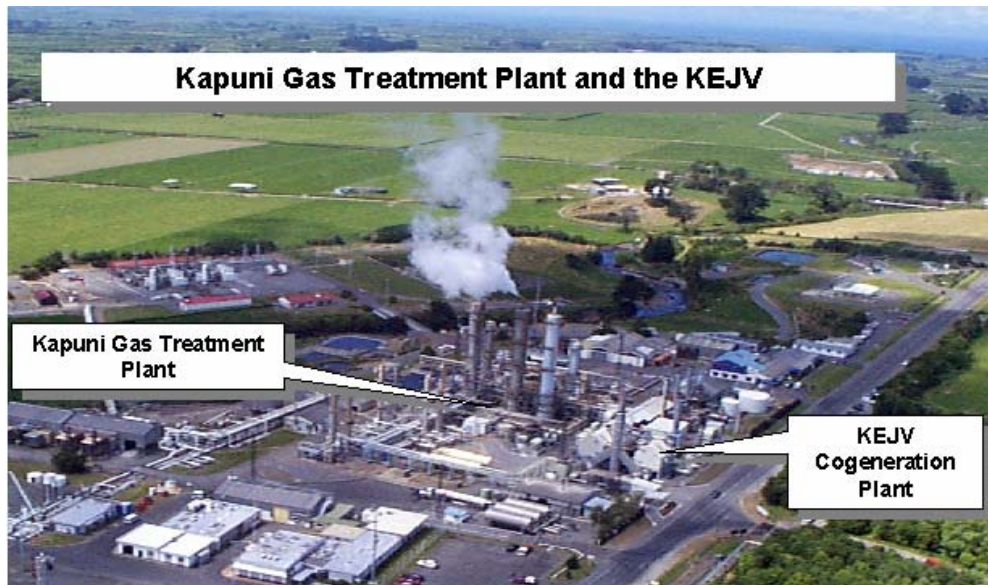
**Diagram 1:
KEJV key commercial and contractual relationships**





Key:	
KEJV	= Kapuni Energy Joint Venture
JVA	= Joint Venture Agreement
Lactose	= The Lactose Company of New Zealand Limited
NGC NZ	= NGC New Zealand Limited
NGC Kapuni	= NGC Kapuni Limited
BOPE	= Bay of Plenty Energy Limited

- 4.8 The KEJV owns the Cogen Plant which is located on site at the KGTP (see the picture below).



- 4.9 The Cogen Plant has a rated output of 25MW. Vector understands that, from gas supplied by NGC, the Cogen Plant produces steam and electricity for supply to the KGTP and Lactose and supplies surplus electricity to BOPE.
- 4.10 Vector understands that if the Cogen Plant does not operate, the KEJV will be unable to meet its downstream obligations to provide electricity and steam to NGC NZ and Lactose and electricity to BOPE and that shut down of the Cogen Plant would almost certainly force the closure of Lactose's plant as it has no ready alternative to the steam provided by the KEJV.¹
- 4.11 Vector also understands that the supply of steam is critical for the operation of the KGTP, and is an essential part of the processing of treated natural gas from raw Kapuni gas.

Management

- 4.12 The KEJV is managed and controlled by a Management Committee, which consists of representatives from both NGC and BOPE.

Operation and Maintenance of the Plant by NGC

- 4.13 The Cogen Plant has been operated and maintained by NGC NZ on the terms of an agreement (the *O&M Agreement*) that expired in January 2004. The O&M Agreement was put out to tender in August 2003. Although NGC NZ was the preferred tenderer, it appears that BOPE and NGC Kapuni are in

¹ Kapuni Limited v Bay of Plenty Electricity Limited, High Court, reported 24 March 2004

dispute as to the terms upon which NGC NZ will operate and maintain the Plant, particularly the price. That dispute has been referred to arbitration. In addition, the parties are in dispute over an arrangement for O&M services on an interim basis and earlier this year, NGC Kapuni unsuccessfully sought an injunction requiring BOPE to "take all steps necessary to enable the KEJV to accept either the offer of 23 January or 19 February 2004, made by NGC NZ as the previous provider of O&M services, to enter into a further interim arrangement based on the previous O&M [Agreement]". Vector is not aware whether this arbitration has taken place but understands that, despite the fact that the O&M Agreement is not currently in force, NGC NZ continues to operate and maintain the Cogen Plant on its terms.

- 4.14 Vector understands that NGC NZ's operational duties in relation to the Cogen Plant are controlled from a room which is integrated with the control room for the KGTP.

Electricity supply business under the EIR Act

- 4.15 The KEJV is an electricity supply business pursuant to section 5 of the EIR Act because it:

- (a) sells electricity in New Zealand to the KGTP, Lactose and BOPE (section 5(1)(a)(i));
- (b) generates electricity in New Zealand (section 5(1)(a)(iii));
- (c) has the benefit of a contract to sell electricity to the KGTP, Lactose and BOPE (section 5(1)(c)(ii)); and
- (d) is not exempted from being an electricity supply business under any of the exemptions set out in sections 5(2) and 5(3) of the EIR Act.

- 4.16 NGC NZ is a separate electricity supply business because it operates a generator (the Cogen Plant) pursuant to the O&M Agreement (section 5(1)(b)), and is not exempted from being an electricity supply business under section 5(2) or (3) of the EIR Act.

Details of NGC's involvement in electricity supply businesses

- 4.17 NGC Kapuni is involved in an electricity supply business pursuant to section 7 of the EIR Act because:

- (a) it carries out the business of the KEJV together with its associate, BOPE² (section 7(1)(a));
- (b) it exceeds the 10% threshold in respect of the KEJV because, as Vector understands it, it has more than 10% of the control rights in the KEJV, and more than 10% of the equity return rights in the KEJV (section 7(1)(b) and sections 8(a) and (b)); and
- (c) it has material influence over the KEJV (section 7(1)(c)).

4.18 NGC Holdings and the NGC group is involved in an electricity supply business pursuant to section 7 of the EIR Act because:

- (a) it exceeds the 10% threshold in respect of both the ownership of the KEJV and the operation of the Cogen Plant by NGC NZ because it has more than 10% of the control rights in both businesses respectively (section 7(1)(b)); and
- (b) it has material influence in relation to both the KEJV and NGC NZ (section 7(1)(c)).

Conclusion on implications of the EIR Act

4.19 Having regard to the above, any acquisition by Vector (which is involved in an electricity lines business) of AGL's interests in NGC Holdings (which is involved in an electricity supply business) and any further acquisition of shares in NGC Holdings, would result in a breach of the cross-involvement prohibition in section 17 of the EIR Act, unless an exemption is granted pursuant to this application.

4.20 None of the exceptions in the EIR Act, or the proposed amendments to it, that allow electricity lines companies to be involved in electricity generation apply in this instance, as illustrated in the table on the following page. In summary, the Cogen Plant either exceeds the permitted capacity thresholds for existing generation or comes within the proposed new thresholds for generating capacity but does not fall within the exception because the Cogen Plant was commissioned before the relevant date.

² NGC Kapuni and BOPE are "associated" in this instance by virtue of the definition of "associate" in section 12(1)(g) of the EIR Act.

EIR Act Section	Permitted involvement in generation	Application to Kapuni Co-generation Plant
s5(2)(a)	Selling or generating less than 2.5 GWh per annum	Plant generates more than 2.5 GWh per annum
s5(2)(e)	<p>Generating electricity from distributed generation (being generator(s) connected to a local distribution network, or to an end-user load that is connected to a local distribution network, and not directly connected to the national grid) and selling the electricity generated, where:</p> <p>(i) the generating capacity of the distributed generation is no more at any one time, than the greater of 5MW (determined according to nameplate or nameplates) and 2% of the maximum demand, in the immediately preceding financial year, of the system [lines] to which the distributed generation is connected; and</p> <p>(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.</p>	<p>Plant is distributed generation</p> <p>Plant exceeds 5MW or 2% of maximum demand. Plant is connected to the local network at the Stratford grid exit point. Maximum demand on this local network is understood to be around 40MW per annum.</p> <p>Here the generation is not connected to lines owned by Vector.</p>
s5(3)	Generating electricity at a generator or generators that are existing, and capable of generating electricity, as at 23 June 1998, if the total generating capacity (determined according to nameplate) of the business, together with its associates (if any) is 5MW or less.	Plant exceeds 5MW
s46A(1)(a)	<p>Generating electricity from new <i>distributed</i> generation using only –</p> <p>(i) a new renewable energy source; or</p> <p>(ii) 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).</p>	<p>Proposed amendments remove requirement for new generation to be “distributed”.</p> <p>Plant is an existing scheme that does not utilise renewable energy sources and fossil fuels provide more than 20% of the total fuel energy input.</p> <p>Also, Plant is not “new” distributed generation.</p>
s46A(1)(c)	Owning or operating, directly or indirectly, new <i>distributed</i> generation, or any other core generation assets used in connection with new distributed generation, that is capable of generating electricity referred to in paragraph (a).	<p>Proposed amendments remove requirement for new generation to be “distributed”</p> <p>Plant is not capable of utilising renewable energy sources or 20% or less fossil fuel.</p>
Proposed new s46C(1)	<p>Generating electricity from generation commissioned on or after 20 May 2003 and selling the electricity generated, if the generating capacity of the generation is not more, at any one time, than the greater of [50] MW (determined according to the nameplate or nameplates) or [20%] of the maximum demand, in the immediately preceding financial year, on the lines owned or operated by the person.</p> <p>Generating reserve energy and selling the electricity generated in accordance with the terms and conditions for that reserve energy set by the Commission, as those terms are defined in the Electricity Act 1992.</p>	<p>Generating capacity within limits – ie less than [50] MW or [20%] of the maximum demand.</p> <p>Plant commissioned before 20 May 2003.</p> <p>Plant not generating reserve energy.</p>
s5(2)(b)	Generating or selling electricity solely for its own consumption or for the consumption of its associates.	A portion of the output of the Plant is for consumption of one of the owners.
s5(2)(c)	<p>Generating electricity solely for the consumption of a local community where:</p> <p>(i) the generator is owned or operated by a business that also conveys electricity by line; and</p> <p>(ii) both those lines and that generator are not connected directly or indirectly to the national grid.</p>	A portion of the output of the Plant is for consumption of local businesses (ie the KGTP and the Lactose plant).

5 GROUNDS FOR APPLICATION

- 5.1 Vector considers that an exemption is appropriate in these circumstances because the cross-involvement that would result from any transaction of the nature described above will not, for the reasons outlined below, offend against the stated purpose and underlying policy of the EIR Act (including the recent policy amendments and the resulting proposals to amend the EIR Act.)

Commission's Three Primary Questions

- 5.2 In considering applications for an exemption pursuant to section 81 of the EIR Act, the Commission has stated in the EIR Act Practice Note that it will consider the following three questions:

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?
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?
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?

- 5.3 Each question is addressed separately below. However, Vector considers that, given the imminent amendments to the EIR Act (resulting from proposals initially set out in the Electricity and Gas Industries Bill), the Commission's questions should also be considered in the context of those amendments. At the date of this application, the third reading of the proposed amendments to the EIR Act is scheduled for 5 October 2004 (at which time the amendments are expected to be passed into law). Therefore, the proposed amendments are clearly relevant to (and depending on timing may well be the appropriate legal basis for) the Commission's consideration of this exemption application.

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?

- 5.4 The relevant markets that would relate to the merged group's cross-involvements are the national electricity generation market, the national electricity retail markets and the electricity distribution market relevant to Vector's electricity distribution network.

National Electricity Generation Market

- 5.5 The output from the KEJV is negligible in terms of the national electricity generation market, as it makes up less than 0.5% of the national electricity generation market.
- 5.6 This factor, and the wider regulatory considerations noted in section 7, indicate that the merged group would accrue no advantages or benefits from its cross-involvement that would affect competition in the national electricity generation market, or in any other way raise policy concerns under the EIR Act.

National Electricity Retail Markets

- 5.7 Vector would have no ability or incentive to inhibit competition in the national electricity retail market by virtue of any acquisition of AGL's interest (and any further shares) in NGC Holdings because:
- (a) as Vector understands it, the generation outputs of the KEJV are entirely dedicated to the KGTP for its own use, Lactose for use at its neighbouring dairy plant and BOPE for sale as it sees fit, under agreed contractual arrangements;
 - (b) Vector understands that the electricity sold to NGC for use at the KGTP is used entirely within the KGTP for operational purposes, and is not on-sold or used elsewhere. Were NGC not to have access to electricity from the KEJV, it would have to purchase it from another generator or retailer;
 - (c) BOPE is free to do what it wishes with the electricity purchased from the KEJV. Vector understands that, currently, BOPE exports the electricity from the KEJV to the national grid via its 110 kilowatt transmission line and on-sells that electricity through the wholesale electricity market;
 - (d) the Cogen Plant (located in Kapuni, Taranaki) is physically separated from the nearest Vector local distribution network (located in Wellington), and from the nearest Transpower transmission network (located 11 kilometres away) so that any physical connection of the KEJV assets with Vector assets is impossible.
- 5.8 These factors, and the wider regulatory considerations noted in section 7, indicate that the granting of an exemption will not create any opportunities or incentives for the merged group to inhibit competition in the national electricity retail markets, or in any other way raise policy concerns under the EIR Act.

Local Electricity Distribution Market

- 5.9 The only potential issue for competition in local electricity distribution markets is the possibility of cross-subsidisation. However, the regulatory regime that would apply to the merged group's electricity lines business discourages and inhibits cross subsidisation (see section 7 for further discussion).

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?

- 5.10 The Commerce Commission has previously stated:

"The Commission considers that incentives or opportunities to cross-subsidise generation activities from electricity lines businesses are potentially present whenever cross-involvements exist."

(Decision 332, Alpine Energy Limited, Paragraph 56)

- 5.11 However, Vector observes here that Decision 332 was issued in February 1999. Subsequently, with effect from August 2001, Part 4A of the Commerce Act was introduced. The Part 4A regime discourages and inhibits opportunities for cross-subsidisation.

- 5.12 However, Vector notes that incentives and opportunities would, in any event, be absent in this instance because:

- (a) Vector understands that the outputs of the KEJV are dedicated to the KGTP for its own use, Lactose for use at its neighbouring dairy plant and BOPE for sale as it sees fit;
- (b) the existing Vector lines networks are geographically remote from the KEJV, and BOPE owns the transmission lines into the KEJV;
- (c) the KEJV, which owns the Cogen Plant, is a 50/50 joint venture with BOPE and as such, were any acquisition to occur, it is unlikely that the merged group could make decisions in relation to the operation of the Cogen Plant without BOPE agreement. It can be expected that BOPE will not agree to anything inconsistent with the efficient operation of the Cogen Plant on commercial terms;
- (d) to the extent that any incentives did exist (and Vector considers they do not), any incentive for the merged group to cross-subsidise the operation of the KEJV would be further diluted, as half of any transfer would go directly to BOPE.

- 5.13 For these reasons, the granting of the exemption for the merged group's cross-involvement will not create any incentives or opportunities for cross-subsidisation between the KEJV generation activities and Vector's electricity lines business.

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?

- 5.14 Vector considers that compliance with the arms length rules in Schedule 1 of the EIR Act (the *Arms Length Rules*) is not necessary in this circumstance. Any acquisition of AGL's interest in NGC Holdings or any further acquisition of shares would not create any incentives or opportunities to inhibit competition in any relevant market, or any incentive or ability to cross-subsidise generation through electricity lines business activity or vice-versa. Neither the purpose of the EIR Act or the purpose of the Commerce Act would be prejudiced if the Arms Length Rules were not implemented in this instance, particularly having regard to the current regulatory environment (discussed further below).

6 OPERATION OF KEJV PLANT BY NGC NZ

- 6.1 The arguments advanced above in relation to the involvement in the ownership of the KEJV by the merged group also apply in relation to the operation of the Cogen Plant by NGC NZ.

7 WIDER REGULATORY CONSIDERATIONS

- 7.1 In considering any application for exemption under the EIR Act, the Commission should consider other regulatory initiatives that have occurred since the EIR Act came into effect and the extent to which the objectives of the EIR Act are met by those initiatives.
- 7.2 Since the EIR Act was passed, there has been significant regulatory activity that was not present at the time structural separation was required. The purposes of the Act are now addressed by:
- (a) the regulatory regime for lines businesses in Part 4A of the Commerce Act (specifically, performance thresholds, an information disclosure regime, and, if thresholds are breached, the threat of investigation by the Commission and, if required, control);
 - (b) industry processes, such as the streamlining of network use of system agreements which make discrimination in favour of one retailer over another very difficult, if not impossible; and

- (c) other existing and proposed regulatory measures available to the Commerce Commission and the Electricity Commission.
- 7.3 In particular, the Part 4A regime, a regulatory regime focussed solely on electricity lines businesses, effectively ring-fences the distribution services (and, therefore, the distribution part of relevant businesses), and enables the Commission to explicitly consider the efficiency and profitability of distribution operations.
- 7.4 The effect of the regulatory regime is that any attempt to cross-subsidise generation or retail activity from the lines component of a business would be transparent to the Commission, either:
- (a) through performance monitoring through the regulatory period;
 - (b) the resetting of thresholds; and
 - (c) if a threshold was breached, through business-specific investigation by the Commission.
- 7.5 Further, as noted above, the establishment of the Electricity Commission has been accompanied by significant regulation making powers across the electricity industry, many of which are either targeted at or have some impact on the performance of lines companies.
- 7.6 Overall, in the presence of existing regulatory initiatives and a wide range of other regulatory threats, there is no scope for cross-subsidisation of generation activities by lines businesses.

New regulation addresses EIR Act purposes

- 7.7 Section 2(1) of the EIR Act states the purpose of the Act as:
-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 –
- 7.8 Section 2(1) also provides for the above purpose to be achieved by:
- (c) effectively separating electricity distribution from generation and retail; and
 - (d) promoting effective competition in electricity generation and retail.
- 7.9 As understood by Vector (based on the relevant policy papers and Government communications around the time the EIR Act was

promulgated), the policy rationale underpinning the EIR Act is that, in the absence of structural separation, there is:

- (a) potential for efficient retail competition to be deterred by (where distribution businesses also operate in retail):
 - o retail operations being cross-subsidised by the distribution business;
 - o discriminatory lines pricing by distributors to favour their own retail operations;
 - o discriminatory behaviour by distributors generally, including fears that the distributor-owned retailer would be advantaged by perceptions that their customers would be favoured first following any outage; and
- (b) difficulty ring-fencing the distribution service activity, including identifying any excess profits in distribution businesses that are perceived to offer a monopoly service.

7.10 When structural separation occurred in 1998, there was no direct regulation of distribution businesses. Instead, general competition law and information disclosure regulations were relied on for disciplining conduct and monitoring performance.

7.11 In August 2001, Part 4A of the Commerce Act was enacted to give the Commerce Commission special powers to develop and implement a regulatory regime specifically for electricity lines businesses. As part of this regime, the Commission was (and continues to be) required to set thresholds and assess lines businesses against them. Any lines businesses that breach the thresholds may be investigated by the Commission and, if necessary, controlled. The Commission was also given powers to set information disclosure requirements and the general investigatory powers under the Commerce Act were also accorded to the Commission to further assist in this area.

7.12 Since being directed by Parliament, the Commission, with the assistance of interested parties (including lines businesses), has made significant headway implementing the regulatory regime. Thresholds were set for an initial period (and lines businesses assessed against them), and then reset to apply for five years. The Commission has been guided by the Purpose Statement of Part 4A, which, in essence, focuses on ensuring efficient and fair outcomes for consumers over time. In setting the thresholds, the Commission has explicitly considered the efficiency and profitability of lines businesses' operations.

7.13 Further, as noted above, proposed amendments to the Electricity Act confer significant regulation-making powers on the Electricity Commission, including in areas related to the performance of distributors. Of particular relevance to the issues considered here are regulation-making powers³ providing for:

“a price methodology or methodologies for recovery of the revenue requirement of electricity distributors”

“terms and conditions on which line owners and electricity distributors must enable electricity generators to be connected to distribution lines”;

“terms and conditions for the use of lines and related services by electricity retailers”; and

“the disclosure of information by electricity retailers and electricity distributors on tariffs and other charges”.

7.14 Any concerns that the EIR Act addressed in relation to cross ownership of electricity lines and electricity generation are now addressed by the regulatory initiatives that have occurred since the EIR Act came into effect, the work of industry processes in pricing approaches, model contracts and other relevant areas, and other regulation-making powers that exist (or are soon to exist). This alone should be grounds for granting the exemption sought.⁴

Proposed amendments to EIR Act to permit additional generation

7.15 It is significant that the proposed amendments to the EIR Act (through the Electricity Industry Reform Amendment Bill, formerly comprised in the Electricity and Gas Industries Bill), will permit distributors to invest in generation equivalent to 20% of annual loads or 50MW, whichever is the larger, and to invest in unlimited renewable generation.⁵

7.16 The fact that the EIR Act allows unlimited generation in renewables by electricity lines businesses:

³ Reference to these regulation-making powers should not be seen as support for them. In Vector’s view, they are not required; or are already, or could be, addressed through existing processes or by the Commerce Commission’s Part 4A regime.

⁴ Vector considers that in light of the Commerce Commission’s regulatory regime for electricity lines businesses, and the regulation-making powers proposed to be conferred on the Electricity Commission, the policy rationale for structural separation of the electricity industry is no longer valid and legislation should be introduced to allow the reintegration of the generation, distribution and retail functions of the industry. Vector has already written to the Minister of Energy, the Deputy Prime Minister and the Chair, Commerce Select Committee.

⁵ At the date of this application, the new extended limits are scheduled to receive their third reading on 5 October 2004 (at which time it is expected that they will be passed into law).

- (a) signals, in principle, that Government sees an important role for lines businesses in generation; and
- (b) undermines the policy rationale for not allowing lines businesses unlimited opportunity to invest in any type of generation, renewable or otherwise.

Government Policy Objective

- 7.17 The cross involvement of the merged group in electricity distribution and generation outlined in this application would not adversely impact the Government's over-arching policy objective:

"to ensure that electricity is delivered in an efficient, fair, reliable and environmentally sustainable manner to all classes of consumer".

- 7.18 Addressing each of the four elements of this policy:

- (a) *Efficient pricing:* the Commerce Commission's thresholds and any investigations of the price path threshold are, inter alia, focused on ensuring distributors' prices, revenues and profits are reasonable over time. Furthermore, all distributors are already required to publish their pricing methods. New regulation-making powers conferred on the Electricity Commission also allow for focus on distribution pricing arrangements.
- (b) *Fairness:* In this context, fairness is assumed to relate to non-discriminatory pricing of, and access to, distribution networks. As noted above, existing regulations, processes and regulation-making powers address these issues.
- (c) *Reliability:* The Commerce Commission's Part 4A regulatory regime focuses on reliability as a key outcome. The Commission has set a quality threshold that requires no material deterioration in reliability performance over time. In addition to reliability performance, the Commission's quality threshold also requires meaningful engagement with consumers. This entails distribution businesses demonstrating to the Commission that they have undertaken such engagement to better understand consumer preferences, particularly with respect to understanding trade-offs between price and quality.
- (d) *Environmental sustainability:* There is no reason to believe that outcomes with respect to environmental sustainability would be any different with the cross ownership that is the subject of this application. Involvement in generation and distribution will still be subject to the same statutory and regulatory constraints and requirements that presently apply to investors in those areas.

8 **ADJUDICATION FEE**

Enclosed is the adjudication fee of \$11,250 (inclusive of GST) payable to the Commerce Commission. In accordance with regulation 3 of the Electricity Industry Reform Act (Fees) Regulations 1998, a refund is requested of any proportion of this fee where the actual cost of processing this application is less than \$11,250.

9 **DECLARATION**

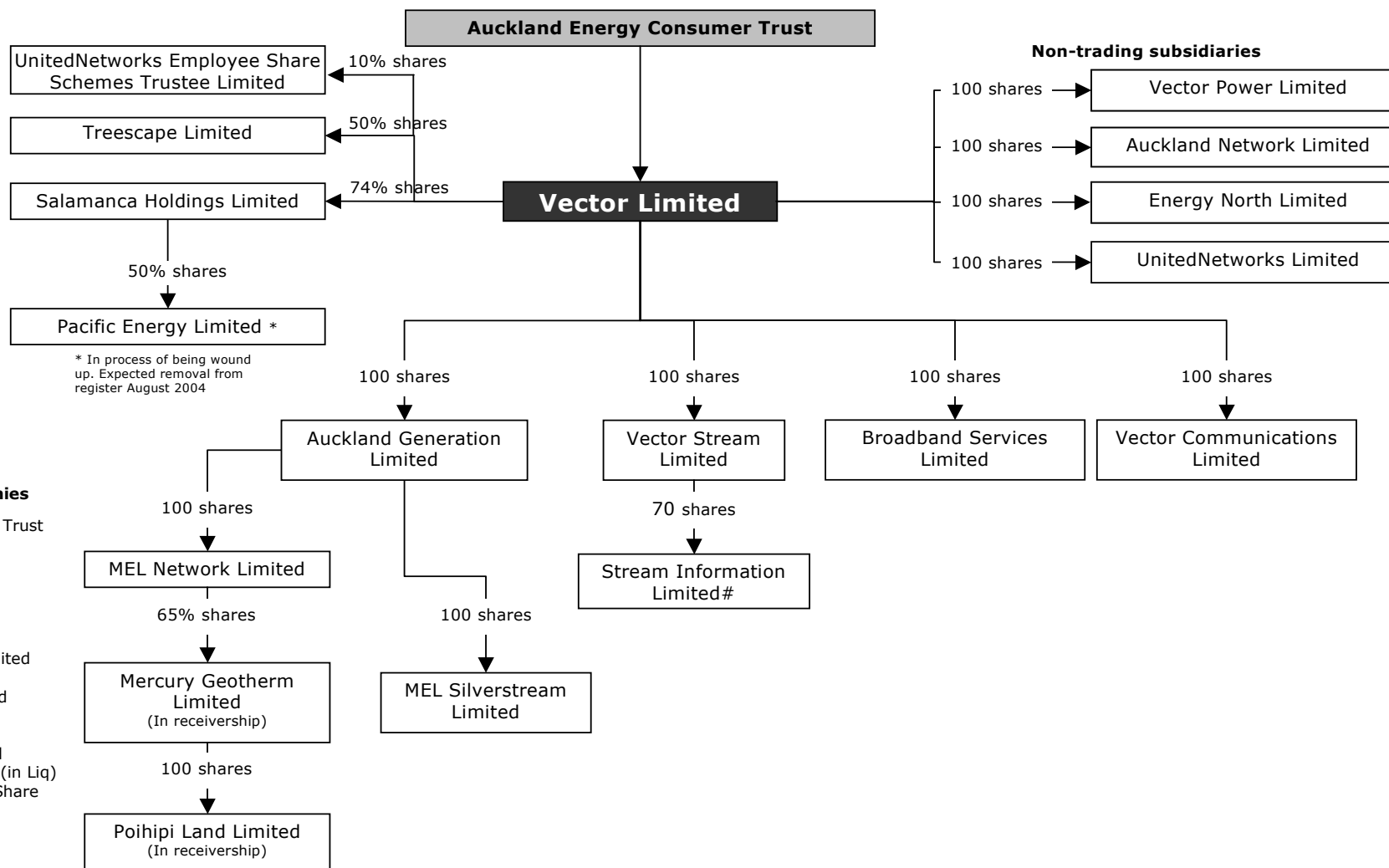
Attached to this application as Appendix C is a completed declaration form.

10 **FURTHER INFORMATION**

If the Commission requires any further information in relation to this application for exemption, please contact the Applicant's Contact, as set out on the front page of this application.

APPENDIX A – VECTOR GROUP STRUCTURE

PUBLIC COPY

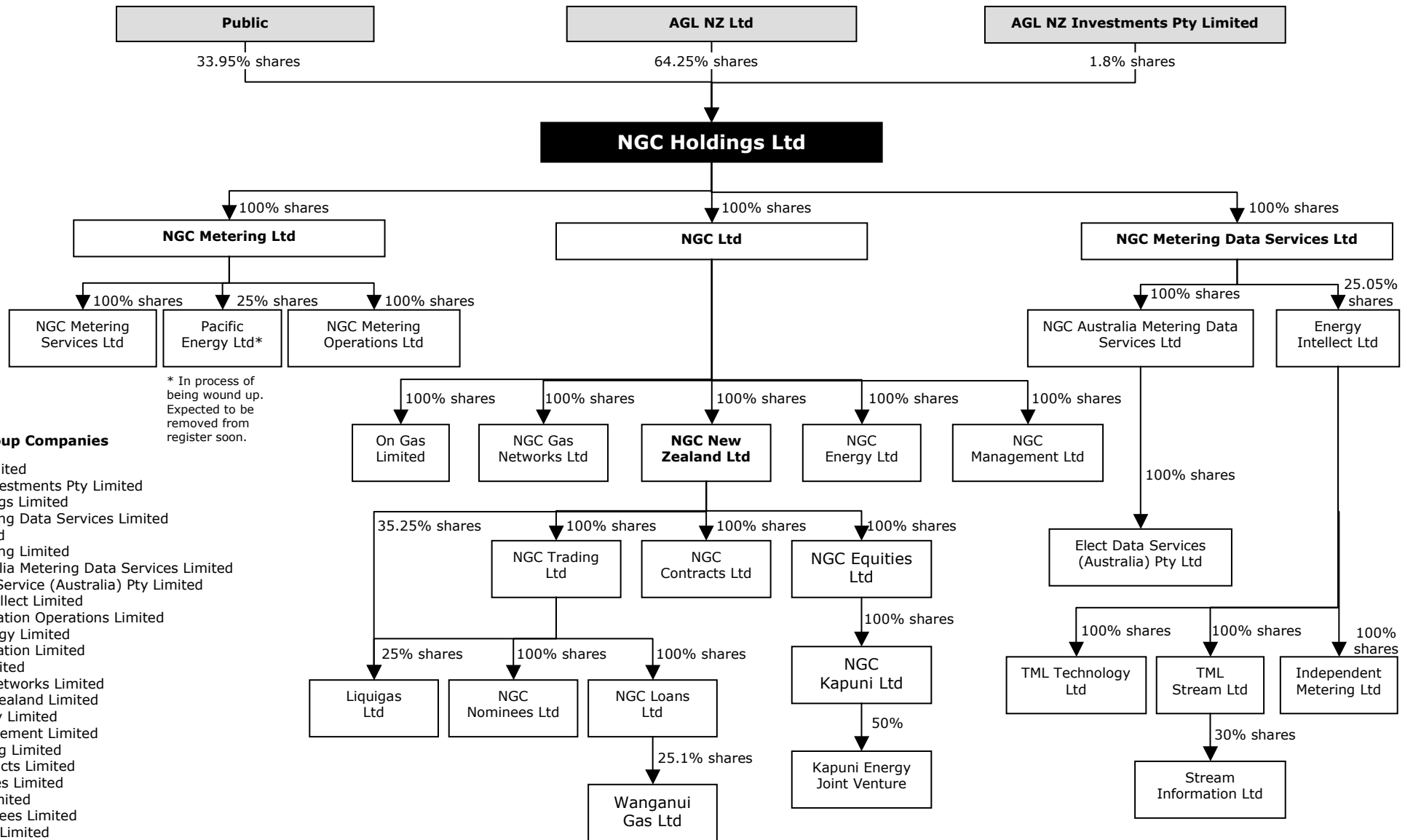


*NGC Metering Limited also holds 25% of the shares in Pacific Energy Limited

TML Stream (which is owned by Energy Intellect Limited) holds 30% of the share in Stream Information Limited

APPENDIX B - NGC GROUP STRUCTURE

PUBLIC COPY



List of NGC Group Companies

1. AGL NZ Limited
2. AGL NZ Investments Pty Limited
3. NGC Holdings Limited
4. NGC Metering Data Services Limited
5. NGC Limited
6. NGC Metering Limited
7. NGC Australia Metering Data Services Limited
8. Elect Data Service (Australia) Pty Limited
9. Energy Intellect Limited
10. NGC Generation Operations Limited
11. Pacific Energy Limited
12. NGC Generation Limited
13. On Gas Limited
14. NGC Gas Networks Limited
15. NGC New Zealand Limited
16. NGC Energy Limited
17. NGC Management Limited
18. NGC Trading Limited
19. NGC Contracts Limited
20. NGC Equities Limited
21. Liquigas Limited
22. NGC Nominees Limited
23. NGC Loans Limited
24. NGC Kapuni Limited
25. Wanganui Gas Limited
26. Kapuni Energy Joint Venture

* In process of being wound up. Expected to be removed from register soon.

APPENDIX C - DECLARATION

THIS APPLICATION is made by Vector Limited

Vector hereby confirms that:

- all information requested by the Commerce Commission has been supplied;
- all information known to Vector which is relevant to the consideration of this application has been supplied to the Commerce Commission; and
- all information supplied by Vector to the Commerce Commission is correct as at the date of this application.

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

Date:

Signed by:

Mark Franklin
Vector Limited

I am the Chief Executive Officer of Vector Limited and am duly authorised to make this application.