



COMMERCE COMMISSION

Decision No. 541

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 Electricity Industry Reform Act 1998 (EIR Act). The application is made by:

VECTOR LIMITED

The Commission:

P R Rebstock
D R Bates
D F Curtin

Summary of the Application:

Vector Limited seeks an exemption, pursuant to s81 of the EIR Act, in relation to a prohibited cross-involvement in an electricity lines business and in an electricity supply business that would arise as a result of its proposed acquisition of up to 100% of the shares of NGC Holdings Limited.

Determination:

The Commission, pursuant to s81 of the EIR Act, exempts Vector Limited from the application of sections 17 and 18 of the EIR Act in relation to a cross-involvement that would arise as a result of its proposed acquisition of up to 100% of the shares in NGC Holdings Limited. The exemption is subject to the terms and conditions stated in the Notice of Exemption.

Date of Determination:

10 December 2004

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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INTRODUCTION

- 1 In concurrent Applications, dated 11 October 2004 Vector Limited has applied for:
 - clearance to acquire up to 100% of the shares in NGC Holdings pursuant to s66 of the Commerce Act 1986 (the Acquisition); and
 - for exemption from ss 17 and 18 of the EIR Act in respect of a prohibited cross-involvements in an electricity lines business and an electricity supply business that would be created as a result of the acquisition.
- 2 On 22 October 2004, Vector Limited (Vector) amended its Application to include three additional involvements to which the EIR Act would apply if the proposed Acquisition proceeded. These interests are:
 - NGC's 25.1% shareholding in Wanganui Gas, an electricity retailer; and
 - two electricity price hedge contracts owned by NGC, which it intends to sell.

COMMISSION PROCEDURES

General

- 3 For the purpose of considering this application for exemption, the Commission, in terms of s58 of the EIR Act which applies s105 of the Commerce Act 1986 to the EIR Act, has delegated its powers under s81 of the EIR Act to P R Rebstock, Chair; D R Bates QC and D F Curtin, Commissioners.
- 4 The Commission's decision is based on an investigation conducted by its staff and their subsequent advice to the Commission.

Criteria Used by the Commission to Consider Exemption Applications

- 5 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.3.¹
- 6 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

¹ Practice Note No.3, September 1998, Electricity Industry Reform Act 1998 Commission's Role and Processes.

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.”

7 The Commission noted in Practice Note No.3 that:

“...the EIR Act provides for maximum cross-ownership limits and specific structural and behavioural requirements to ensure that the purposes of the Act are met. Strict compliance with these limits and requirements is, other than in exceptional circumstances,⁽²⁾ expected.”

8 The Commission stated in Practice Note No.3 that:

“On receipt of an application in the prescribed form, the Commission will determine whether granting an exemption would be contrary to any element of the particular purpose of Parts 1 to 5 of the EIR Act or the overall purpose of the Act.

The Commission’s tests would necessitate obtaining and evaluating objective answers to the following questions in relation to the particular purpose of Parts 1 to 5 of the EIR Act:

- Would the Commission, by granting an exemption in respect of a business or involvement or interest, create incentives or opportunities to inhibit competition in the electricity industry?
- Would the Commission, by granting an exemption in respect of a business or involvement or interest, create incentives or opportunities to cross-subsidise generation activities from electricity lines businesses?
- Would the Commission permit, by granting an exemption in respect of a business or involvement or interest, a relationship between an electricity lines business and an electricity supply business which is not at arms length?

In relation to these questions, the Commission will consider factors such as:

- The relevant market(s)³ within the electricity industry;
- The nature of any incentives or opportunities created;
- The temporal nature of any incentives or opportunities created;
- The nature of any relationship which is not at arms length; and
- The temporal nature of any relationship which is not at arms length.

PARTIES

The Applicant

Vector Limited (Vector)

9 Vector is the owner and operator of about 25,000 kilometres of electricity lines in greater Auckland and Wellington which distribute electricity to 642,000 consumers in those regions.

10 Vector is wholly owned by the Auckland Energy Consumers Trust.

² For example, of the types provided for in s19 of the EIR Act.

³ Defined using the same process as used for market definitions in respect of Commerce Act matters.

Other Parties

NGC Holdings (NGC)

- 11 NGC is a publicly listed company whose main business is the wholesaling, transmission, distribution and retailing of natural gas. It also has businesses in the LPG industry and in electricity and gas consumption metering.
- 12 More relevant to Vector's application, NGC also:
 - owns and operates a 50% interest in the Kapuni Energy Joint Venture (KEJV). The KEJV owns a Co-generation plant (Cogen Plant) at the Kapuni Natural Gas Treatment Plant (KGTP);
 - owns 25.1% of the shares in Wanganui Gas Ltd, an electricity retailer; and
 - owns and intends to sell two contracts which hedge against electricity prices.

The Cogen Plant

- 13 The Cogen Plant is located at, and provides electricity and steam to power the KGTP. The remaining electricity generated by the Cogen Plant is contractually committed to Fonterra's Lactose New Zealand plant and Bay of Plenty Energy Limited (BOPE). These electricity sale and purchase contracts expire on [] respectively.
- 14 NGC has a 50% interest in the KEJV with Todd Energy owning the other half. The KEJV owns the Cogen Plant which is located on the same site as the KGTP. The KGTP, owned by NGC, is used to treat natural gas by removing carbon dioxide and LPG before it is transmitted to consumers. The Cogen Plant has a rated output of 25 megawatts. The electricity not consumed by NGC at the treatment plant is transmitted by BOPE to Fonterra's lactose plant and to the national grid.
- 15 The KEJV is managed and controlled by a Management Committee which consists of representatives from both NGC and BOPE. To date NGC have operated and maintained the Cogen Plant and continue to do so [].

Wanganui Gas Limited (Wanganui Gas)

- 16 NGC owns 25.1% of the shares of Wanganui Gas. The remaining shares are owned by the Wanganui City Council. Wanganui Gas distributes and sells natural gas. Since April 2002, it has also supplied about [] gigawatt-hours of electricity per annum as a retailer to about [] residential consumers in the Wanganui region.
- 17 NGC is permitted to appoint two directors of six to the Board of Wanganui Gas, and has done so.

The Electricity Hedge Contracts

- 18 These contracts are owned by NGC and are a residue of the period when it was an electricity generator and retailer. NGC has advised the Commission that it is in the process of selling the two contracts. The contracts are:
 - An electricity price hedge arrangement where NGC []

and

- An electricity price hedge arrangement where NGC []].

Bay of Plenty Electricity Limited (BOPE)

- 19 BOPE is based in Whakatane and is a wholly owned subsidiary of Todd Energy Limited. It is a supplier of gas and electricity in the Bay of Plenty region.

INVOLVEMENTS AND PROHIBITED CROSS-INVOLVEMENTS

- 20 Vector has conceded that, if the Acquisition proceeds, it would be cross-involved in an electricity supply business and an electricity lines business in respect of the Cogen Plant and the shareholding in Wanganui Gas. Vector has submitted that it is not entirely clear that NGC falls within the definition of ‘electricity supply business’ in the EIR Act by virtue of its interests in the hedge contracts.
- 21 An analysis of involvements, prohibited cross-involvements and the relevant statutory provisions are set out below.

Relevant Statutory Provisions

- 22 Section 17 of the EIR Act 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.”

- 23 It is necessary to consider in relation to the Application whether Vector and NGC are, or will be, “involved” (as defined in s7 of the EIR Act) in an “electricity lines business” and “electricity supply businesses” (as those terms are defined in s4 and 5 of the EIR Act respectively).
- 24 The definition of “electricity lines business” appears in s4(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.”

- 25 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.”

26 The EIR Act provides for the definition of “electricity supply business” in s5(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:
 - (i) Generates electricity in New Zealand:
 - (ii) 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.”

27 Subsection (2) provides for a number of exemptions from s5(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 5MW (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.

28 Section 46A and C of the EIR Act provide for certain involvements in generation activities to be excluded from the operation of the ownership separation rules as follows:

“46A. Exemption for new...generation from a renewable energy source-

- (1) The following activities do not cause any person to breach the ownership separation rules:
 - (a) generating electricity from new...generation using only-
 - (i) a new renewable energy source; or
 - (ii) a new renewable energy source and fossil fuels if fossil fuels provide no more than 20% of the total fuel energy input for the generator or generators comprising the generation plant in any 12 month period...
 - (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).

“46C. Exemptions for generation commissioned after 20 May 2003 and for reserve energy-

- (1) The following activities do not cause any person to breach the ownership separation rules:
 - (a) generating electricity from generation commissioned on or after 20 May 2003, and selling the electricity generated, if the generating capacity of the generation is no more, at any one time, than the greater of 50 MW (determined according to nameplate or nameplates) or 20% of the maximum demand, in the immediately preceding financial year, on the lines owned or operated by that person:
 - (b) 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.
- (2) Subsection (1) applies only if and as long as sections 24 and 25 (corporate separation and arms length rules) are complied with.

29 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.”

30 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.

31 Section 81(1) of the EIR Act provides the Commission with its powers 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.

Electricity Lines Businesses and Involvements

32 Vector is an electricity lines business pursuant to s4 of the EIR Act because it:

- a) conveys electricity by line in New Zealand (s4(1)(a));
- b) owns and operates lines and other core assets of an electricity lines business in New Zealand (s4(1)(b)); and
- c) is not exempted from being an electricity lines business under any of the exemptions set out in s4(2) of the EIR Act.

33 Vector is “involved” in an electricity lines business pursuant to s7 of the EIR Act because it:

- a) carries on that business (s7(1)(a));
- b) exceeds the 10% threshold (as defined in s8 of the EIR Act) in respect of that business (s7(1)(b));
- c) has material influence over the business (s7(1)(c)); and

- d) owns and operates the core assets comprising the business (s7(3)).

Electricity Supply Businesses Involvements

The KEJV

- 34 NGC is an electricity supply business pursuant to s5(1)(b) of the EIR Act because, directly or indirectly via the KEJV, it owns and operates a generator (the Cogen Plant) in New Zealand and is not exempted under s5(2), 46A or 46C.

Wanganui Gas

- 35 Wanganui Gas is an electricity supply business pursuant to s5 of the EIR Act because it:
- sells electricity in New Zealand (s5(1)(a)(i)); and
 - owns core assets of an electricity retail business, including the customer data base relating to and used for the purposes of an electricity retail or electricity trading business (s5(1)(c)(i)).
- 36 NGC is involved in Wanganui Gas as it exceeds the 10% threshold and has material influence over the business.
- 37 None of the exceptions in s5 of the EIR Act apply to NGC's involvement in Wanganui Gas. In particular:
- Wanganui Gas sells approximately [] gigawatt-hours per annum of electricity, above the 2.5 gigawatt-hour per annum exception in s5(2)(a); and
 - Wanganui Gas sells electricity to end-consumers and not solely for its own consumption and accordingly the exception in s5(2)(b) does not apply.

The Two Electricity Price Hedge Contracts

- 38 Vector has submitted that it is not clear that NGC falls within the definition of "electricity supply business" in the EIR Act by virtue of its interests in the hedge contracts.
- 39 Vector has submitted that NGC is not a "business" that sells financial hedges and therefore does not fit within the definition of 'electricity supply business' under s5(1)(a)(ii). Vector submitted that before entering into the back to back arrangements that are currently in place in relation to the two hedge contracts, NGC was the purchaser under the hedge contracts, its position as a "seller" coming about only as a consequence of the on-sale of the contracts in the context of the sale of its electricity retail business. The Applicant further added that the hedges are residual obligations [] and are not part of a "business" of selling financial hedges.
- 40 In terms of both the electricity hedge arrangements electricity is purchased by NGC and then on-sold to another party. Although not a typical arrangement in respect to the sale of electricity the Commission is of the view that NGC is selling electricity in New Zealand pursuant to s5(1)(a)(i) of the EIR Act and therefore is an electricity supply business.

Conclusion on NGC's Involvements in Electricity Supply Businesses

- 41 The Commission considers that NGC is involved in electricity supply businesses in respect of its involvement in the KEJV, Wanganui Gas and two electricity price hedge contracts.

Prohibited Cross-Involvements

- 42 If the proposed Acquisition proceeds, Vector, by reason of its ownership of at least 66.05% (that is, before taking account of any shares it might acquire from minority shareholders of NGC) will be involved with NGC because it will exceed the 10% threshold and will have material influence over the business. If NGC is an electricity supply business, then post-acquisition, Vector as a electricity lines business will have a prohibited cross-involvement.

THE EXEMPTION SOUGHT BY VECTOR LIMITED

- 43 Vector seeks a permanent exemption from the application of s17 and 18 of the EIR Act in relation to these prohibited cross involvements.
- 44 Vector submitted that an exemption is appropriate in these circumstances because the cross-involvement that would result from any transaction of the nature described above would not offend against the stated purpose and underlying policy of the EIR Act (including the recent policy amendments and the resulting amendments to the EIR Act.)

EXAMINATION IN TERMS OF THE COMMISSION'S CRITERIA

- 45 The Commission is of the view that the relevant markets in this instance are the national electricity generation market, the national electricity retail market and the electricity distribution markets corresponding to Vector's electricity distribution networks.
- 46 Set out below is analysis of each of the three questions which the Commission considers in relation to exemption applications under s81 of the EIR Act.

Incentives or Opportunities to Inhibit Competition in the Electricity Industry

Would the Commission, by granting an exemption in respect of a business or involvement or interest, create incentives or opportunities to inhibit competition in the electricity industry?

- 47 The EIR Act requires the separation of electricity distribution functions (lines) and electricity retailing and generation functions (supply) in order to enhance competition and choice in respect of supply. The EIR Act recognises that the market power of an electricity lines business enables the use of various mechanisms to inhibit competition in electricity retailing. Such mechanisms include:
- charges to electricity retailers for access to lines and contract administration charges over and above line charges;
 - cross-subsidies from line charges to electricity retail charges; and
 - delays in permitting electricity retailers to have access to lines through use-of-system contractual arrangements.
- 48 The Commission is of the view that, in most cases, cross-involvement in electricity lines and supply businesses will create incentives and opportunities to inhibit competition in the supply of electricity. Competition can be inhibited; for example, by imposing unreasonable line charges and access terms in respect of the lines business, or cross-subsidising electricity sales from line charges. The incentives relate to the ability to

supply electricity to consumers without facing competition from other electricity retailers.

In relation to the Cogen Plant

- 49 The Applicant has submitted that the output from the KEJV is negligible in terms of the national electricity generation market making up less than 0.5% of the total output. The Applicant submitted that this factor, and the wider regulatory considerations noted below, 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.
- 50 Vector submitted that it would have no ability or incentive to inhibit competition in the national electricity retail market by virtue of the proposed acquisition because:
- the electricity generated by the KEJV is entirely contractually committed to the KGTP, Fonterra's Lactose Plant, and BOPE;
 - the electricity sold to NGC for use at the KGTP is consumed entirely within the Plant 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 connect its plant to the local distribution network of Powerco;
 - 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; and
 - the Cogen Plant (located in Kapuni, Taranaki) is physically separated from the nearest Vector local distribution network (located in Wellington).
- 51 Vector further submitted that the Commission should consider other regulatory initiatives that have occurred since the EIR Act first came into effect and that these regulatory changes ultimately affect the context in which the application for exemption should be viewed. Specifically Vector made reference to:
- 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);
 - 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
 - other existing and proposed regulatory measures available to the Commerce Commission and the Electricity Commission.
- 52 In addition Vector submitted that the recent amendments to the EIR Act, namely permitting distributors to invest in generation equivalent to 20% of annual loads or 50MW, whichever is the larger, and to invest in unlimited renewable generation, is an important consideration. Vector submitted that the amendments are significant as the fact that the EIR Act allows unlimited generation in renewables by electricity lines businesses:
- signals, in principle, that Government sees an important role for lines businesses in generation; and

- undermines the policy rationale for not allowing lines businesses unlimited opportunity to invest in any type of generation, renewable or otherwise.

53 Finally, NGC submitted that the supply of steam from the Cogen Plant is critical for the operation of the KGTP [

].

54 The Commission has been informed, [

].

55 The Commission considers that recent amendments to the EIR Act refer to investment in new generation and do not relax the ownership separation requirements in respect of existing generation. Whilst the Commission considers that it should take account of the recent amendments to the Act in a relevant case, it notes that the recent amendments do not address the potential cross-involvement which has led to Vector's Application for exemption.

56 In this case, another relevant consideration is that all of the residual electricity generated at the Cogen Plant is contractually dedicated to BOPE until []. The residual electricity is defined as all of that which is not supplied to Fonterra's Lactose Plant, or purchased by NGC for use in relation with the operation of the KGTP.

57 NGC submitted the following table illustrating the percentages of the volumes (in MWh/annum) of electricity which was sold to the parties.

Table One: Electricity Sold by the KEJV

Sold to:	YTD 30 Sept 04		Y/E 30 June 04		Y/E 30 June 02	
NGC	[]	[]	[]	[]	[]	[]
Fonterra	[]	[]	[]	[]	[]	[]
BOPE	[]	[]	[]	[]	[]	[]

58 The table illustrates that the electricity used by NGC is a relatively small proportion of the total generated by the Cogen plant. The Commission is of the view that, but for BOPE's contractual entitlement to all of the surplus electricity, Vector may have incentives or opportunities to inhibit competition in the electricity industry post acquisition. However, the fact that the electricity is contractually dedicated until [] removes those opportunities in the short term.

59 The Commission wishes to maintain that position once the current electricity sale contracts from KEJV expire. It, therefore, is of the view that the following condition is required as part any exemption it grants.

Unless otherwise permitted by law, neither Vector Ltd nor NGC Ltd or any of their wholly or partially owned subsidiaries shall purchase a quantity of electricity from the Kapuni Energy Joint Venture which is greater than that necessary or desirable to operate the Kapuni Natural Gas Treatment Plant at any time.

In relation to the Electricity Price Hedge Contracts

- 60 NGC have advised the Commission that, in respect of the first hedge, [] In respect of the second hedge, []
- 61 As NGC is currently seeking to exit its involvement in the two electricity hedge arrangements, the Commission is of the view that there are no incentives or opportunities created, in respect of Vector's future cross-involvement, to inhibit competition in the electricity industry.
- 62 The Commission is of the view that the transfer of NGC's interests in the hedge arrangements should be effected within six months of the granting of this exemption or the completion of the proposed acquisition (whichever is the later). Accordingly, the Commission is of the view that it is appropriate to make the exemption subject to the condition that involvement in both electricity hedge arrangements must cease within six months. Specifically:
- Vector must cease its involvement in both the electricity price hedge contracts owned by NGC and involving NGC in back to back arrangements between [] and [] on the later of:
- i. six months of the date on which this exemption takes effect; or
 - ii. six months from the creation of the cross-involvement,
- whichever is the later date.

In relation to Wanganui Gas

- 63 Wanganui Gas, although being primarily a retailer and distributor of natural gas, entered into a electricity supply arrangement with Mighty River Power in April 2002 to allow it to become a dual fuel retailer to residential consumers in Wanganui and the Rangitikei region.
- 64 Vector submitted that it would have no ability or incentive to inhibit competition in the national electricity retail market by virtue of the proposed Acquisition because:
- Wanganui Gas does not retail electricity to consumers connected to Vector's electricity networks;
 - Wanganui Gas retails electricity to only approximately [] residential consumers and accordingly it only has a very small share of the national electricity retail market;
 - NGC owns only 25.1% of the shares in Wanganui Gas. The majority 74.9% shareholding of Wanganui Gas is held by Wanganui District Council. Accordingly, to the extent that any incentives or opportunity to inhibit competition did exist (and Vector considers they do not), NGC's minority interest in Wanganui Gas would be insufficient to direct Wanganui Gas to take advantage of those incentives or opportunities; and
 - there are a number of electricity retailers of considerably greater size and substance than Wanganui Gas, backed by generation interests, who continue to supply residential, commercial and industrial end-consumers.
- 65 Vector submitted that these considerations combined with the wider regulatory considerations (noted above) indicate that the granting of an exemption in relation to the Wanganui Gas Activity 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 or affect the achievement of outcomes in the Government's Policy Statement on electricity.

- 66 The Commission is of the view that despite Vector's proposed technical cross-involvement in an electricity supply business and an electricity lines business no incentives or opportunities to inhibit competition in the electricity industry will be created by virtue of NGC's shareholding in Wanganui Gas. As Vector has submitted, the fact that Wanganui Gas does not sell electricity to consumers connected to Vector's electricity networks is an important consideration. Competition concerns are more likely to arise in a situation where control over an electricity distribution network would create an advantage, vis-à-vis other electricity retailers, in supplying electricity across that network. In this case Vector would be unable to influence the access terms of retailers who compete with Wanganui Gas on Powerco's Wanganui and Rangitikei distribution networks. The Commission considers that no incentives or opportunities to inhibit competition in the electricity industry will be created as long as Wanganui Gas does not retail electricity over Vectors electricity networks.
- 67 The Commission further notes that any attempt by Vector to cross-subsidise its Wanganui Gas electricity retail interest from its lines businesses, would result in three quarters of any such subsidy being, in effect, paid to the other owner of Wanganui Gas, the Wanganui District Council. Given this fact, the implementation of such a subsidy does not appear to be a commercially sensible pattern of behaviour and in the Commission's view, unlikely to occur.
- 68 Therefore, the Commission considers that it is appropriate in this case to grant an exemption subject to a condition that maintains the status quo. Accordingly, the Commission exempts Vector from the application of the EIR Act in respect of NGC's involvement in Wanganui Gas, as an electricity supply business, for as long as Wanganui Gas does not sell electricity to consumers connected to Vector's electricity distribution networks. This condition ensures that there will continue to be no opportunity for the cross-subsidisation of lines activities through involvement in the retailing of electricity. As a result the Commission will make its exemption conditional that:

Unless otherwise permitted by law, Vector will not contract with Wanganui Gas or electricity customers of Wanganui Gas for the provision of electricity lines services during any period in which Vector is involved in an electricity supply business as defined by the EIR Act.

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?

- 69 Vector has submitted that despite the Commission's earlier statement that "incentives or opportunities to cross-subsidise generation activities from electricity lines businesses are potentially present whenever cross-involvements exist"⁴ the regulatory environment has significantly changed. It submitted that in particular the introduction of Part 4A of the Commerce Act in 2001 significantly discourages and inhibits opportunities for cross-subsidisation by electricity lines businesses.

⁴ Decision 332, Alpine Energy Limited, Paragraph 56.

- 70 Further, Vector submitted that incentives and opportunities would be absent in this instance because:
- the outputs of the KEJV are committed to the gas treatment plant, Fonterra's Lactose Plant and BOPE ;
 - the existing Vector lines networks are geographically remote from the KEJV, and BOPE owns the transmission lines into the KEJV. There is no apparent non-transparent means by which Vector might cross-subsidise the KEJV; and
 - 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.
- 71 The amendments to the EIR Act which permit additional electricity generation to be owned by electricity lines companies apply only to generation from renewable fuels and new generation commissioned after 20 May 2003. That does not apply to the Cogen Plant. As such the Commission has analysed whether the resulting cross-involvement would create incentives or opportunities to cross subsidise generation activities from lines business involvements.
- 72 The Agreement for supply of electricity between the Joint Venture and BOPE provides that BOPE will purchase all of the residual energy from the joint venture less that sold to NGC (for use to operate the gas treatment facility) and Fonterra's Lactose Plant. These contracts will expire on [].
- 73 The Commission is of the view that due to this fact, incentives or opportunities that may be created to cross-subsidise generation activities from lines business involvements are greatly reduced in this case.
- 74 The Commission also notes that the geographic separation of Vector's electricity network from this particular generation asset is an important consideration. The potential for cross-subsidisation is of particular concern where a generator has the potential to connect generation directly to a local distribution network. In this case the generator is not connected to Vector's networks but directly to Fonterra's plant and to the national grid by lines owned by another party.
- 75 The Commission is of the view that the opportunities and incentives to cross-subsidise generation activities from involvement in an electricity lines business are minimal and do not present a material risk to the purposes of the EIR Act. This view arises primarily as a result of the bulk of the electricity generated being contractually dedicated to other parties and because another party owns the lines connecting the generator to the national grid.

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 Vector has submitted that compliance with the arms length rules in Schedule 1 of the EIR Act (the Arms Length Rules) is not necessary in this circumstance. It has submitted that the proposed acquisition would not create any incentives or opportunities to inhibit competition in any relevant market, or any incentive or ability to cross-subsidise generation from an electricity lines business. Vector submitted that neither the purpose of the EIR Act or the purpose of the Commerce Act 1986 would be prejudiced if the Arms Length Rules were not implemented in this instance, particularly having regard to the current regulatory environment as discussed above.
- 78 Further, in respect of the prohibited cross-involvement that would arise in respect of Wanganui Gas Vector submitted that:
- “The nature of NGC’s shareholding is such that the outcome of NGC’s involvement is similar, in a practical sense, to the operation of the Arms Length Rules. NGC is not involved in the day to day management of Wanganui Gas (and does not have the ability to vote itself a place in that management) and, as a minority shareholder is not able pass resolutions relating to the direction or management of Wanganui Gas. Wanganui District Council’s 74.9% interest in Wanganui Gas will ensure that Wanganui Gas operates independently and in its own best interests.”
- 79 The Commission is of the view that despite a relationship being created that would not be at arms length the analysis in respect of the first two exemption test questions above shows that the proposed acquisition would result in such a relationship having little practical effect in terms of the conduct which the EIR Act was designed to prevent.
- 80 The exemption would be subject to the terms and conditions outlined above and restated below in the Notice of Exemption. These conditions would ensure that there are no incentives or opportunities created by the prohibited cross-involvement that would inhibit competition in the electricity industry and also ensure that cross-subsidisation of generation from electricity lines should not occur.
- 81 Accordingly, the Commission does not consider that the potential effects of a relationship not at arms length resulting from the proposed Acquisition to be a material risk to the purpose of the EIR Act.

THE COMMISSION’S DECISION

- 82 The Application meets the criteria used by the Commission to decide upon exemptions from the EIR Act, assuming the specified conditions are met.
- 83 The exemption is applicable to Vector’s cross-involvement arising as a result of its proposed acquisition of up to 100% of the shares of NGC Holdings Ltd, which is an electricity supply business due to its ownership of:
- half of Cogen Plant,
 - the two electricity price hedge contracts; and
 - NGC’s shareholding in Wanganui Gas,
- and is subject to the terms and conditions specified by the Commission in the Notice of Exemption.
- 84 In making its decision the Commission notes that the facts revealed in the Application are particular to Vector’s situation alone. The Commission also notes that s81(5) of the EIR Act provides that the Commission may vary or revoke any exemption at any time.

NOTICE OF EXEMPTION

The Commission, pursuant to section 81 of the Electricity Industry Reform Act 1998 (the EIR Act), exempts Vector Ltd from the application of sections 17 and 18 of the EIR Act in respect of the “cross-involvement” (as that term is defined in the EIR Act) that would be created upon its acquisition of up to 100% of the shares in NGC Holdings Ltd.

The cross-involvement exempted comprises Vector Ltd’s involvement in its electricity lines business and its potential involvement in NGC Holdings Ltd which is an electricity supply business by virtue of NGC Holdings Ltd’s ownership of:

- half of the Kapuni Energy Joint Venture electricity generation scheme;
- two electricity price hedge contracts owned by NGC Holdings Ltd by which NGC Holdings Ltd: buys electricity from [

]; and
- 25.1 % of the shares of Wanganui Gas Ltd, an electricity supply business.

The exemption does not apply to cross-involvements created as a result of the proposed acquisition by Vector Ltd of NGC Holdings Ltd, other than those which occur because of NGC Holdings Ltd’s ownership of the assets listed above.

The above exemption is subject to the following terms and conditions:

- a) Unless otherwise permitted by law, neither Vector Ltd nor NGC Holdings Ltd nor any of their wholly or partially owned subsidiaries shall purchase a quantity of electricity from the Kapuni Energy Joint Venture which is greater than that necessary, or desirable, to operate the Kapuni Natural Gas Treatment Plant at any time.
- b) Vector Ltd must cease its involvement in the two electricity price hedge contracts owned by NGC Holdings Ltd within:
 - i. six months of the date on which this exemption takes effect; or
 - ii. six months from the creation of the cross-involvement,
 whichever is the later date.
- c) Unless otherwise permitted by law, Vector Ltd will not contract with Wanganui Gas Ltd for the conveyance of electricity over Vector Ltd’s electricity lines for the purpose of allowing Wanganui Gas Ltd to sell electricity to consumers connected to Vector Ltd’s electricity lines during the period when Vector Ltd continues to have the relevant cross-involvement, in terms of the EIR Act.

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

The Commission may vary or revoke this exemption at any time in accordance with s81(5) of the EIR Act.

Dated this 10 day of December 2004

Paula Rebstock
 Chair
 Commerce Commission