

# **Investment in Electricity Generation by Lines Companies**

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# 1. Introduction

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1. In March 2005 the Ministry of Economic Development (the Ministry) released a discussion paper entitled “Facilitating Investment in Generation by Lines Companies: a discussion note”.
2. The purpose of that note was to open up a discussion on how lines companies’ investment in generation can be facilitated (short of completely removing current ownership restrictions). Industry views were sought on a specific proposal to amend the legislation to allow lines companies to trade in hedge and spot energy markets up to the nominal capacity of their generating plant.
3. As part of the consultation process, several other options have been suggested. Specifically, there were proposals aimed at further relaxation of some aspects of the Electricity Industry Reform Act 1998 (EIRA), with some suggesting that without a complete overhaul of the Act effective participation of the lines businesses in the electricity generation market would not be possible.
4. The Ministry has considered the industry suggestions and possible options on how the effects of unnecessary barriers to lines companies’ investment in generation could be minimised. The primary purpose of this discussion paper is to promote a further discussion with the industry on the issues of lines and energy separation.
5. This discussion paper firstly sets out the current regulatory settings and the policy rationale underpinning those. The next sections outline the perceived legislative barriers and options for addressing those. The last sections of this paper present the Ministry’s analysis, draw some conclusions and invite industry comment.
6. The Ministry’s response to requests for clarification or further detail of the proposal to allow lines companies to trade in hedge and spot energy markets up to the specified limits, as raised in the previous submissions, is provided in Appendix 1 to this paper. The list of submitters is included as Appendix 2.

## 2. Current Legislative Provisions

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7. Submissions showed that there is a range of understandings of the current legal framework and the ability of lines companies to invest in generation. This section outlines the current legislative provisions, relevant policy objectives and policy settings designed to achieve the objectives.

### 2.1 Electricity Industry Reform Act

8. **Table 1** below summarises the current regulatory settings and the policy objectives of the Electricity Industry Reforms Act 1998 and its subsequent amendments. More detailed consideration is outlined below.

#### 2.1.1 Electricity Industry Reform Act 1998

9. The Government's concern at the time was that local electricity companies, being vertically integrated natural monopolies, had both the ability and incentive to use their market power in distribution to discourage competition in retail and generation. The Government accepted the view that companies in this position can and do use their market power to benefit their owners to the detriment of consumers. Structural regulation (i.e. ownership separation) was preferred over conduct regulation as the means to deliver the best outcomes to consumers.
10. To this end, the Electricity Industry Reform Act (EIRA) was introduced in 1998. The Act required full ownership separation between lines (distribution and transmission), and energy supply (generation and retail) businesses.
11. The key provisions of the Act prohibiting cross-ownership are:
- section 17 prevents persons that are involved in an electricity lines business from being involved in an electricity supply business and *vice versa*;
  - section 18 provides that persons involved in one type of electricity business (e.g. lines business) may not acquire an interest in the other type of electricity business (e.g. generation) if it would result in a 20% aggregate of control rights or equity return rights in the generation business by persons involved in the lines business, and vice versa;
  - section 20 applies cross-ownership prohibitions, similar to those found in sections 17 and 18, to trust-like entities.<sup>1</sup>
12. At the time the Act came into effect, owners of the power companies, which were to be separated, were also given an option (as an alternative to full divestiture of generation and retail businesses) to set up mirror trusts, which, if chosen, required full corporate separation (i.e. creation of a separate legal entity) and arms length management, as per sections 24 and 25 of the Act.

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<sup>1</sup> Section 19 excludes certain types of businesses from the ownership separation rules, such as financiers. This exclusion is noteworthy but does not require discussion for the purposes of this paper.

**Table 1: Electricity Industry Reform Act 1998**

	<b>Electricity Industry Reform Act 1998</b>	<b>Electricity Industry Reform Amendment Act 2001</b>	<b>Electricity Industry Reform Amendment Act 2004</b>
	<b>POLICY OBJECTIVES</b>		
	<b>Minimise opportunity and incentive to lessen competition in retail and generation markets</b>	<b>Retain original objectives and:</b>	
		<b>Facilitate efficient use of distributed generation to support line function services and promote new renewables</b>	<b>Promote increased security of supply and competition in generation market</b>
<b>POLICY SETTINGS</b>	Prohibition on cross involvement of supply and energy	Exception to own distributed generation up to the higher of 5MW or 2% of lines' peak load	Exception to own generation up to the higher of 50 MW or 20% of lines' peak load capacity limits and unlimited reserve energy, commissioned after 20 May 2003
		Exception to own unlimited distributed generation from new renewable sources	Exception to own unlimited generation from new renewable sources
		Exception for selling the output of cross-owned generation	
	Prohibition on trading in financial instruments		
	Requirement for arms-length corporate separation of cross-owned line and energy businesses	Exception for up to 5MW or 2 percent of peak demand	
Case by case exemptions available			

13. The arms-length rules require companies in common ownership to act independently and as if they were in separate ownership, thus prohibiting any person to have material influence on both kinds of business. The rules, as specified in section 25 and Schedule 1 of the Act, include, among other things:

- requirement for separate and independent management and directorship;
- duties not to discriminate in favour of the other company in common ownership or to make any arrangements that unrelated parties would not have made;
- prohibition on sharing information unless it is also available to other parties; and
- requirement for records to be kept of all transactions between the companies in common ownership.

14. Section 81 of the Act provides the Commerce Commission with a wide range of powers to exempt businesses and persons from the provisions of the Act, if the Commission finds that an exemption will be consistent with the purpose of the Act. In the majority of cases, the Commerce Commission has granted exemptions subject to a range of conditions intended to ensure that benefits to consumers are realised.

### **2.1.2 Electricity Industry Reform Amendment Act 2001**

15. The purpose of the Electricity Industry Reform Amendment Act 2001 (2001 Amendment) was to facilitate investment in distributed generation to support line function services. It was considered lines companies should have an option of developing distributed generation facilities instead of undertaking upgrades to their networks where it is economically efficient to do so. Lines companies were recognised as having, in principle, a strong incentive to undertake such investment, but were prevented from doing so under EIRA.
16. The 2001 Amendment Act relaxed the ownership restriction on the basis that it would not seriously threaten the underlying objective of the Act to lessen competition. The Amendment allowed lines businesses to own distributed generation up to the higher of 5MW or 2% of their maximum demand and sell their output, without having to comply with the original cross-ownership requirements (including corporate separation and arms length requirements).
17. Lines businesses were also permitted to own and sell (in unlimited quantities) the output of generation from new renewable energy sources, such as wind, connected to their network. However, companies taking this option were still required to comply with the corporate separation and arms-length rules, if the capacity of their renewable generation plant exceeded 5MW or 2% of their peak load.
18. There are no legal restrictions on lines companies selling the output of their generation to anyone, including to end-consumers, by whatever contractual arrangements they wish (subject to only selling their own output). Lines businesses are, however, prohibited by the legislation from trading in financial instruments to hedge risks (other than financial transmission rights).

### **2.1.3 Electricity Industry Reform Amendment Act 2004**

19. The purpose of the Electricity Industry Reform Amendment Act 2004 (2004 Amendment) was to promote security of supply and greater competition in the generation market.
20. The 2004 Amendment relaxed the restrictions on new non-renewable generation by allowing cross-ownership of up to the higher of 50MW or 20% of lines' peak demand and unlimited reserve generation contracted to the Electricity Commission. The Amendment also retained lines companies' ability to invest in new renewable generation in unlimited quantities. However, any generation capacity above 5MW or 2% of peak demand remained subject to corporate separation and the arms-length rules.
21. The requirement for generation to be connected to the lines company's network (i.e. to be "distributed generation") was removed. It was considered to be unnecessarily restrictive and prevented, for example, a remote wind project being connected to the grid or another company's network even where it would be more efficient to do so.

## 2.1.4 The Electricity Industry Reform Act Today

22. The current provisions of the Act make a clear distinction between new and existing generation. Generation capacity producing electricity from renewable sources is considered to be 'new' if it was commissioned after 7 August 2001. Generation capacity producing electricity from non-renewable sources, is considered to be 'new' if commissioned after 20 May 2003. Generation plants commissioned prior to these dates are considered to be 'existing generation'. The cross ownership restrictions, introduced by the original 1998 legislation and described in paragraphs 9 to 14 above, are still relevant for the purposes of cross involvement in existing generation capacity.
23. However, different rules apply to businesses and individuals wishing to be involved in cross-ownership of new generation capacity. These are briefly summarised below:
- **Investment in new renewable<sup>2</sup> and reserve energy (without quantity limits):** Lines companies are permitted by the legislation to invest in unlimited quantities of renewable energy and reserve generation contracted to the Electricity Commission. They are also no longer restricted by the legislation to have these generation facilities connected to their local networks.
  - **Investment in non-renewable energy (up to certain quantity limits):** Lines companies' investment in generation of up to the higher of 50MW or 20% of lines' maximum demand has been exempted from the requirements of the original cross ownership provisions. As with renewables and reserve energy, there is no requirement for the generation to be connected to the local network.
  - **Investment in diversified portfolios of generation (up to certain quantity limits):** The current legislative provisions do not restrict a lines company from owning (wholly or partially) more than one generating plant, as long as the total capacity of the lines companies generation portfolio is within the limits specified. For example, a lines company could invest in three generating plants (commissioned on or after 20 May 2003) of 25MW, 15 MW and 10MW each.
  - **Selling generation output:** The current legislation provides for lines companies' ability to sell the output of their own generation by whatever contractual arrangements they wish (subject to selling only their own output). Lines companies are, however, prohibited from trading in financial instruments (other than financial transmission rights)
  - **Governance requirements:** Generation capacity above 5MW or 2 per cent of lines' maximum demand is required to be operated by a separate corporate entity and subject to arms length rules. The arms-length rules require companies in common ownership to act independently and as if they were in separate ownership, thus prohibiting any person to have material influence on both kinds of business.

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<sup>2</sup> It should be noted that new renewable energy, as defined in section 46A of the Electricity Industry Reform Act does not include hydro or geothermal energy sources comprising a generation plant that has an aggregate generating capacity of more than 5MW, unless approved by the Minister.

- **Exemption Regime:** Section 81 of the Act provides the Commerce Commission with a wide range of powers to exempt businesses and persons from the provisions of the Act, if in any particular case the Commission finds that an exemption will be consistent with the purpose of the Act.

## 2.2 Other Relevant Provisions

### 2.2.1 Targeted Control of Lines Businesses and Information Disclosure Regulations

24. In 2001 the Commerce Act 1986 was amended to provide a targeted control and information disclosure regime for electricity lines businesses. It was considered that while EIRA separated the ownership structure to remove potentially anti-competitive cross subsidisation and remove barriers to competition in generation and retail markets, a remaining issue was the risk of monopoly pricing by distribution companies.
25. The purpose of the targeted control regime, as set out in section 57E of the Commerce Act, is to promote the efficient operation of markets directly related to electricity distribution and transmission services through targeted control for the long-term benefit of consumers. This purpose is to be achieved by ensuring that suppliers:
  - are limited in their ability to extract excessive profits; and
  - face strong incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
  - share the benefits of efficiency gains with consumers, including through lower prices.
26. Under the regime, businesses are only potentially subject to control if they cross the set thresholds of performance. The regime is “targeted” because only businesses that cross the thresholds trigger further examination by the Commerce Commission. If the Commerce Commission considers it to be necessary it can introduce control of prices, revenues and/or quality of lines businesses services.
27. The purpose of the information disclosure regime, as set out in section 57T of the Commerce Act, is to promote the efficient operation of markets directly related to electricity distribution (and transmission) services. The regime aims to ensure that large line owners and large electricity distributors make publicly available reliable and timely information about the operation and behaviour of those businesses, so that a wide range of people are informed about such factors as profits, costs, asset values, price (including terms and conditions of supply), quality, security, and reliability of supply of those businesses.

### 2.2.2 Distributed Generation Regulations

28. Powers to regulate terms and conditions of access to distribution lines by generators were introduced in the 2001 Amendment to the Electricity Act 1992. Draft regulations are currently being developed. The purpose of these regulations is to mitigate barriers (price or non-price related) that distributors might erect against generators.

### 3. Why Consider Further Amendments to the Electricity Industry Reform Act?

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29. The previous section summarises the constraints that EIRA places on cross-involvement between line and supply businesses and explains the policy reasons for those constraints. This section discusses why further changes to EIRA may be considered. It begins by postulating some benefits from lines companies investing which are not being realised owing to the legislative barriers placed on their activities by EIRA, which if accepted, would support a case for relaxing the current constraints on cross-involvement.

#### 3.1 Propositions

30. There are potential efficiency gains obtainable from close coordination of lines and distributed generation operations. For example, the benefits of co-optimising investment between line upgrades and new generation. However the statutory restrictions in EIRA prevent these gains being realised.

31. Distributors are well-placed to enter generation (and retail) markets because they:

- are more likely than national generators to identify and develop local generation options because they have strong relationships with local communities and good knowledge of local energy resources;
- have existing knowledge and involvement in the electricity industry
- can readily identify opportunities and exploit synergies with coordination between line and generation and demand-side operations (e.g. using generation and/or demand management to avoid network investment); and
- can realise economies of scope by making use of common resources (operations staff, control centres, etc).

32. Reducing barriers to entry for distribution companies may increase the level of competition in generation markets, which should place downward pressure on prices for consumers (provided lines companies do not have incentives to cross-subsidise or use regional market power to reduce competition.)

33. Although distributors are technically permitted to enter the generation market with unlimited quantities of new renewable and limited quantities of other generation, some potential projects may have difficulty being commercially viable because, under EIRA:

- lines companies cannot hedge the financial risks of selling energy at spot prices which may make potential generation projects costly. Lines companies are limited to selling their output either on the spot market, or to other parties able to manage variations in output from lines companies' generation. In practice, such parties are likely to be restricted to the existing vertically integrated generators/retailers and some end-consumers who are willing to organise their own supply at the time of outages and trade on the spot market. This presents lines companies with several difficulties:

- i. Selling on the spot market results in volatile and unpredictable revenue streams, making a project difficult to finance;
  - ii. Selling to other retailers may not be an attractive business proposition because these retailers are also likely to be major generators, and are therefore lines companies' competitors in generation;
  - iii. Retailing to end-consumers, although permitted by the legislation, may not be feasible due to lines companies' inability to meet typical customer requirements, such as fixed prices and an ability to draw variable quantities of electricity.
- compliance costs associated with corporate separation and arms length operation (applicable to projects above 5MW or 2% of system peak) may be too high for smaller projects. Arms length rules require generation to be held by a separate company with a separate board and management structures<sup>3</sup>. Some potential generation projects are not being progressed as a result of the extra costs arms length rules create and the loss of control over investment capital by the board.
34. If the propositions above were accepted, there would be a case for amending EIRA to allow the hedging of financial risks and/or reducing the compliance costs associated with corporate separation and arms length rules in order to:
- capture the efficiency gains obtainable from more integrated operation of lines and distributed generation; and
  - put downward pressure on prices in the generation and/or retail markets by facilitating new entry and increased competition in those markets.
35. However, these potential (or hypothesised) benefits need to be weighed against the potential detriments that EIRA is designed to mitigate, namely, the potential for cross-involved firms to use their market power in the distribution market to lessen competition in the generation and retail markets.
36. Any amount of cross-involvement provides an incentive to lessen competition, but a firm's opportunity to lessen competition is limited by the extent of cross-involvement relative to the size of the relevant market (e.g. cross-involvement in a 10MW generation plant is unlikely to provide much opportunity to lessen competition materially in a 10,000MW market).

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<sup>3</sup> The arms-length rules required companies in common ownership to act independently and as if they were in separate ownership. The rules specified, inter alia:

- Separate management
- Duties not to discriminate in favour of the other company in common ownership or to make any arrangements that unrelated parties would not have made
- Prohibition on sharing information unless it was also available to other parties, and
- Records to be kept of all transactions between the companies in common ownership.

37. The Ministry considers that the proposals described in this paper would result in relatively small changes in the extent of cross-involvement between lines and supply businesses. The central question is whether the benefits arising from relatively limited changes in the amount of cross-involvement would outweigh the costs.

### **3.2 Options for Addressing Legislative Barriers**

38. The Ministry considers the regulatory framework under EIRA is still necessary and therefore is not considering a high level review of the purpose of the Act at this stage. Moreover, the issues of competition levels in electricity market are currently being investigated by the Commerce Commission and also being looked at by the Electricity Commission. Any potential review of the purpose of EIRA would be a consequence to the outcomes of these studies.
39. However, it is appropriate to look at several possible changes within the parameters of the current framework with a view of removing unnecessary barriers to lines companies' ability to investment in generation.
40. Following consideration of the submissions in April 2005, the Ministry has considered the following possible changes to the current policy setting in EIRA. These are to:
- a. Allow Trading in financial instruments
    - Allow the generation entity, owned by a line company's owners, to trade in financial instruments up to the nominal generation capacity of their permitted generating plant.
  - b. Changes to the Arms Length Rules
    - Raise the threshold for arms-length separation above current minimum level (5MW or 2%)
    - Raise the threshold for arms-length separation up to the current cross-ownership limits (50MW or 20%)<sup>4</sup>.
    - Introduce less onerous arms-length requirements for generation projects between the thresholds of 5MW or 2% and 50 MW or 20%. For example, accounting and information separation could be required, but staff, managers and/or directors may be able to provide services for both the lines and generation parts of the distribution company.
    - Provide lines companies with more flexibility to decide how they will meet arms length obligations. For example, in the United Kingdom (UK) electricity distributors develop their own proposals outlining how they will comply with conditions and submit these to the regulator for approval. In Australia, the regulator provides an option where if a distributor considers that they have a better method of ring-fencing that meets the high level objectives, they can seek the regulator's permission to implement it.

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<sup>4</sup> Once companies own generation above 50MW or 20% full corporate separation would still be required.

- Remove the requirement for lines companies to comply with arms length rules when generation owned by a lines company is connected to a different distribution network or the transmission grid, and retail customers (if any) are outside the lines company's network. In this situation, it is suggested the lines company has no conflict of interest with other generation proposals on the local network, and no insider information about customers' energy usage, and therefore that there is no need to impose constraints on lines company involvement in energy supply.
- c. Reducing legislative uncertainty
- Provide criteria in legislation to guide the Commerce Commission and distribution companies in applications for exemptions from the provisions of EIRA. Both the process and the substance of the exemptions regime are currently determined by the Commerce Commission rather than being explicit in the legislation. Some lines companies argue that in order to be in a position to satisfy Commerce Commission questions, a project need to be a long way into its development plan and that guidelines would enable the Commerce Commission to obtain relevant information for decision-making and provide clarity earlier in the exemptions process.
  - Redraft the provisions relating to arms length rules to make the rules more detailed and specific, reducing uncertainty. Some lines companies suggest that the wording of schedule 1 of EIRA is too open to interpretation, and legislation is not clear in terms of prohibitions on staff working for both companies. They suggest there is a need to spell out exactly what is and is not permitted, and include a description of activities and functions rather than titles of individuals performing functions.

## 4. Potential Benefits and Costs of Changes

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41. The Ministry's views of the potential benefits and costs of these changes are outlined below.

### 4.1 Trading in Financial Instruments

#### 4.1.1 Proposed option – allowing lines businesses to trade in hedges and other financial instruments

42. The proposal is to allow the lines businesses to trade in financial instruments up to the nominal generation capacity of their generating plant.
43. The aim of this proposal is to give lines companies access to a wide range of trading arrangements to manage risks and to capture the benefits of owning generation. For example, enabling them to offer continuous supply contracts and manage the associated risks of doing so.
44. The Ministry has already consulted on this proposal<sup>5</sup>. Industry submissions regarding potential merits and ramifications of this proposal have been analysed, and the main benefits and costs/risks of this proposal are as follows:

#### **Benefits**

45. Allowing lines companies limited access to hedge market trading may encourage investment by lines companies in new generation up to the permitted limits by enabling lines companies to better manage revenue flows from their output.
46. An ability to trade in financial hedges will allow lines companies to better manage any supply of electricity they can offer into the market, which may provide them with the ability to sell electricity to retail customers. An increased level of retail competition in local areas is another possible benefit of this proposal, although this increase will be limited to the relatively small output of the generation owned by the lines companies.

#### **Costs/Risks**

47. Electricity generation/retail companies have argued that if lines companies decide to sell their electricity to retail customers as a result of being able to trade in financial hedges, then they may have incentives to favour their own retail supply against competing retailers, or create difficulties for other retailers.
48. This risk is much lower than before ownership separation was introduced because lines companies no longer own the incumbent retailer and use-of-system agreements for competing retailers are in place. This risk will also be reduced by continuing to require lines companies to be subject to appropriate corporate separation and arms length rules, as well as the thresholds (price) control regime. In addition, lines companies' generation and retail activities will be capped at the amount of their own generation.

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<sup>5</sup> "Facilitating Investment in Generation by Lines Companies: a discussion note"  
<http://www.med.govt.nz/ers/electric/generation-investment/index.html> refers

## **Conclusion**

49. The Ministry has already consulted on this proposal. On balance, the Ministry considers that the risks of this proposal are low and there is a good case for allowing lines companies to trade in hedges and related financial instruments to better manage their trading risks for the output from the generation stations they own.

## **4.2 Changes to the Arms Length Rules**

### **4.2.1 Proposed Option – increase the ALR threshold/align the ALR thresholds with the ownership thresholds**

50. The proposal is to raise the threshold for arms-length separation above the current minimum level (5MW or 2% of lines peak load) or up to the current cross-ownership limits (50MW or 20%).
51. It should be noted that raising the threshold to 50MW or 20% would align the arms length threshold with the current cross-ownership limits, effectively removing all statutory constraints on cross-involvement up to the specified capacity limit.
52. By its very nature, a threshold will always be a particular number, and there will be some examples that can be argued should be allowed or disallowed on either side of it. The question is whether a higher threshold would encourage additional investment in generation while ensuring lines companies do not have opportunities to reduce competition. In particular, are there some smaller generation investments that are not viable because of arms-length rules applying? Is there a threshold at which the percentage of costs due to the arms length rules will discourage investment? At what threshold or percentage of the lines company load are competitive concerns in the generation market are likely to become an issue?
53. The proposal to raise the arms-length threshold has been analysed in the context of its impact on lines companies' ability to cross subsidise its generation and retail activities and to lessen competition in generation and retail markets. The likely benefits and costs/risks of this proposal, as seen by the Ministry, are outlined below.

### **Benefits**

54. It is likely that some additional competition or at least threat of competition in generation would take place if the current arms length rules were relaxed. Lines companies have expressed an interest in investing in generation and claimed to have some comparative advantage in doing so, including:
- Involvement in the electricity sector (investment in generation, as argued by lines companies, is a natural extension of their current business activities);
  - Strong balance sheets; and
  - Local presence and knowledge of generation opportunities.
55. While it seems likely that there will be some increase in investment in generation resulting from this proposal, it is unclear how much additional generation is likely to eventuate. By and large, there is no apparent shortage of project proposals or capital for investment in generation. Rather, the main barriers to generation

investment are uncertainty regarding the availability of gas, climate change policies and RMA difficulties. None of these would be affected by the relaxation of the arms length rules.

56. Additional competition in retailing, or the threat of competition, also appears a likely consequence of raising the arms length threshold to 50MW.

### **Costs/Risks**

57. There are several short and long term risks associated with a proposed change in the threshold where arms length rules apply. These are listed below.
58. There is a risk of cross-subsidy from captive lines customers to retailing activities. While this risk has been considerably reduced by the Commerce Commission's threshold regimes, the requirement for stand-alone companies and arms-length rules provides a useful buffer for a regime that has not yet been fully tested.
59. There is a risk that lines companies would favour their own retailer against competing retailers. While this risk is much lower than before ownership separation was introduced, without the requirement for an arms length relationship, the more retailing a lines company undertakes, the more opportunity it has to create difficulties for competing retailers.
60. Similarly there is a risk that lines companies may have opportunities to create difficulties for competing local distributed generation. Potential new entrant generators would be required to reveal commercially confidential plans to the lines company which could also be a competitor.
61. There is also a risk that too much reliance on behavioural regulations (e.g. information disclosure under part 4A of the Commerce Act) would be much less effective than a form of structural separation, such as the current corporate separation accompanied by the arms length governance requirements. While impacting on the underlying incentives, behavioural regulations do not remove the ability of companies to act anticompetitively, are difficult and costly to police and involve a constant "uphill battle" for the regulator.
62. The proposed relaxation of the arms length rules is inconsistent with the internationally accepted argument that other regulatory measures that could be put in place of corporate separation are unlikely to be sufficiently robust to address the implications of vertical integration and information asymmetry. Examples of international approaches from the UK and Australia showing several forms of corporate/legal separation are included as Appendix 3.

### **Conclusion**

63. The Ministry considers that the risk of anticompetitive behaviour by lines companies if the threshold was raised to 50MW may be significantly greater than any potential long term benefit to electricity consumers. It is, therefore, considered that implementation of this proposal, at this stage, is not desirable. However, the Ministry is still evaluating the merits of raising the threshold where arms length rules apply to a level above 5MW or 2%, and will consider submissions addressing this issue.

#### **4.2.2 Proposed Option – apply less onerous requirements for small (up to 50 MW) generation projects**

64. If the threshold for arms-length separation was not raised, another option to consider would be introducing less onerous requirements for arms length rules between the two current thresholds. For example, accounting and information separation could be required, but staff, managers and/or directors may be able to provide services for both the lines and generation parts of the distribution company.
65. There are similar benefits and costs for this proposal as for the proposal to raise the arms-length threshold outlined above. The key question here is whether cross-involvement by individual directors or staff would provide material opportunity for anti-competitive behaviour, for example, misusing information acquired in the lines business.

##### ***Benefits***

66. Less onerous arms length rules may reduce compliance costs for lines companies, as they would not need to meet as many requirements of arms length separation.

##### ***Costs/Risks***

67. Any scheme would need to be carefully designed to avoid possible risks of lines companies favouring their own generation or retail, by misusing the information or knowledge that individual staff or directors may acquire through their involvement in the lines business.
68. As noted above, there is a risk that relying on a greater degree of behavioural regulation would be less effective than having a stronger form of structural separation, such as the current corporate separation and arms length rules. A greater degree of behavioural regulation would not remove the ability of companies to act anticompetitively, would be difficult and costly to police and would involve a constant 'uphill battle' for the regulator.
69. In particular, it is likely that additional monitoring would be necessary. In addition to the price thresholds regime monitoring, it may be necessary to have more active monitoring under EIRA to ensure the purpose of parts 1-5 is met, i.e. that companies are not able to inhibit competition in the electricity industry or cross-subsidise generation activities from electricity lines businesses.

##### **Conclusion**

70. On balance, the Ministry considers that the risk of anticompetitive behaviour by lines companies from making the arms length rules less onerous may be greater than any potential long term benefit to electricity consumers. It is therefore considered that implementation of this proposal is not desirable.

#### **4.2.3 Proposed Option – provide increased flexibility to lines companies to meet their arms length obligations**

71. Provide lines companies with more flexibility to decide how they are going to meet the arms-length requirements. For example, in the UK electricity distributors develop their own proposals outlining how they will comply with conditions and submit these

to the regulator for approval. In Australia, the regulator provides an option where if a distributor considers that they have a better method of ring-fencing that meets the high level objectives, they can seek the regulator's permission to implement it.

### **Benefits**

72. Administrative costs for lines companies could be reduced if greater flexibility were provided for lines companies to implement arms length requirements in a way that is lowest cost for them while still meeting the intent of the rules. Greater flexibility may also lead to more efficient and innovative solutions to reduce costs for lines companies.
73. If arms length costs were reduced, this may also lead to an increased level of investment in generation.

### **Costs/Risks**

74. Decisions on whether arms length requirements have been met may take more time and effort, and have a higher degree of uncertainty. The overall process for implementing arms length requirements would be less clear than if it were specifically defined in legislation. Default arms length provisions would need to be retained in legislation.
75. With a higher degree of flexibility in the application of arms length rules, there may need to be additional monitoring to ensure the intent of the arms length rules was still being complied with. This would lead to greater regulatory costs.
76. There is also a question of how different a process of applying for flexible application of arms length rules would be from seeking an exemption under current legislation. The current exemptions process considers applications on a number of criteria including whether an exemption would create a relationship between an electricity lines business and an electricity supplier which is not at arms length. I.e. it considers whether the arms length rules are being met without meeting the specific provisions of the legislation.

### **Conclusion**

77. On balance, the Ministry considers that the current exemptions regime would take into account cases where lines companies sought additional flexibility in applying arms length rules and does not consider there is a necessity for a separate process, as any process for assessment would be sufficiently similar to the current exemptions process.

#### **4.2.4 Proposed Option – remove arms length requirements for generation connected not to the lines company's own network**

78. Remove the requirement for lines companies to comply with arms length rules when generation owned by a lines company is connected to a different distribution network or the transmission grid, and retail customers (if any) are outside the lines company's network. In this situation, it is suggested the lines company has no conflict of interest with other generation proposals on the local network, and no insider information about customers' energy usage, and therefore that there is no need to impose constraints on lines company involvement in energy supply.

79. Recent decisions by the Commerce Commission on exemption applications from Unison and Eastland Networks are consistent with this proposal. Unison Networks was granted an exemption for a wind farm connected to the transmission grid provided they did not retail the output from this wind farm to customers on their own network. On the other hand, Eastland Networks application for exemption from the provisions of EIRA was declined as Eastland Networks proposed to retail electricity on their own network and the Commerce Commission considered that this would create incentives and opportunities to inhibit competition in the electricity industry.

### **Benefits**

80. Generation not connected to local networks will capture the benefits of any comparative advantage that lines companies have in investing in generation, including involvement in the electricity sector, while not providing incentives for companies to use their knowledge to behave anti-competitively or favour their own generation and retail on their network.
81. The incentive and ability for lines companies to create difficulties for local distributed generation connecting to their network would be removed. Lines companies would be connecting to other distribution networks, so would not be competing on their own networks.
82. Overall there would be less need for arms length requirements as lines companies will not have information they can share with their generation part of the company about the best places to connect generation or information about customers' energy usage. This would lead to reduced compliance costs for lines companies.

### **Costs/Risks**

83. There would still be some risk of lines businesses using the monopoly part of their business to subsidise the competitive parts of their business (generation and retail). Lines companies may still require some sort of accounting/financial separation between competitive generation and monopoly lines businesses to avoid cross subsidisation risks. However this risk is substantially reduced by the Commerce Commission monitoring of the price threshold regime and information disclosure requirements set out in part 4A of the Commerce Act.

### **Conclusion**

84. On balance, we conclude that there is a case for removing the arms length rules when generation is connected to an unrelated network.

## **4.3 Reducing Legislative Uncertainty**

### **4.3.1 Proposed Option – criteria to guide the Commerce Commission in exemption applications**

85. The proposal is to provide specific criteria to guide Commerce Commission and distribution companies in applications for exemptions from the provisions of EIRA.
86. Some lines companies argue that in order to be in a position to satisfy Commerce Commission questions, a project needs to be a long way into its development plan,

and that guidelines would enable the Commerce Commission to obtain relevant information for decision-making and provide clarity earlier in the exemptions process.

87. Currently, the Commerce Commission can make exemptions under section 81 of EIRA. The Commission's Practice Note 3 outlines the criteria that the Commerce Commission uses to decide applications. The Commission will have regard to the particular purpose of parts 1-5 of the Act as defined in section 2(2) of the Act, and the overall purpose of the Act as set out in section 2(1) of the Act, and will not grant exemptions if they believe these will be contrary to this purpose. In particular, the Commerce Commission will evaluate whether an exemption would:
- create incentives or opportunities to inhibit competition in the electricity industry;
  - create incentives or opportunities to cross-subsidise generation activities from electricity lines businesses; or
  - permit a relationship between an electricity lines business and an electricity supply business which is not at arms length.
88. Factors the Commerce Commission considers include the relevant market(s) within the electricity industry, the nature and temporal nature of any incentives or opportunities created, and the nature and temporal nature of any relationship which is not at arms length.
89. The question is whether it would be possible to improve the current process for deciding exemptions by improving clarity and reducing time taken and information required for decision-making. To answer this question requires more information from stakeholders on what they consider to be the issues with the current situation, including time taken for exemption applications to be processed, costs incurred in making an application whether successful or unsuccessful, and any other issues experienced with the process of applying for exemptions. This information would clarify whether providing criteria in legislation would create more certainty around the process of applying for exemptions.
90. At present, it is not clear, given the criteria for decision-making from Practice Note 3, whether additional legislative requirements would help solve process issues, bearing in mind that any legislative guidelines for exemptions also need to ensure exemption applications are consistent with the purpose of the EIRA.
91. Whether legislative criteria would make a difference to the exemptions process will also depend on what those criteria are. One possibility would be to emulate the criteria used in Australia by the Australian Competition and Consumer Commission (ACCC) for testing exemptions from the ring-fencing guidelines for transmission companies. This test requires the ACCC to assess the public benefits of compliance with the obligations in the guidelines and the administrative costs of compliance with the obligations in the guidelines. If the ACCC is satisfied that the administrative cost outweighs the public benefit, the waiver will be granted. In addition, as part of the process of granting a waiver from the ring-fencing guidelines, the ACCC may consider imposing any additional obligations.
92. Before considering whether this legislative test would be useful in the New Zealand context, we would need more information from stakeholders on whether it would simplify exemption applications, including information on how stakeholders could

define and estimate both the administrative costs of applying current arms length rules and what the public benefits of compliance with the rules are.

93. Whether criteria should be added in legislation will depend on whether doing so would improve the process of applying for exemptions and create more certainty. There is a need to also consider whether making criteria compulsory would assist the exemptions process more than including non-compulsory criteria that may be taken into account. The advantages and disadvantages of being more prescriptive in legislation and therefore more certain about the procedure for exemptions are discussed briefly below.

### **Benefits**

94. If specific criteria for deciding exemptions were outlined in legislation it may be easier for lines companies to put together an application for an exemption saying how these criteria will be met, and provide more transparency for applicants. In addition, specific guidelines in legislation might speed up decision-making by the Commerce Commission.

### **Costs/Risks**

95. If the suggested criteria are too detailed and prescriptive, or are compulsory, rather than simply criteria which may be taken into consideration, this may lead to a lack of flexibility around exemptions, which may make it harder to give some generation projects appropriate consideration and slow down the process of consideration of exemptions. Whether this is the case will depend strongly on what proposed criteria are, so there is a need to ensure any particular criteria proposed would in fact facilitate the exemptions process.
96. If guidelines are not outlined in legislation, then any decision on an exemption may have the effect of creating a precedent which the Commerce Commission and the industry will look to for guidance in future applications.
97. There have only been two applications relating to exemptions from arms length rules for major lines companies to build *new* generation decided under the Act. These are Eastland Networks' application for an exemption to build and operate a wind farm located at Mokairau, and retail the electricity produced on its own network, and Unison Networks' application for an exemption to develop and operate a wind farm in the Hawkes Bay, which would be connected to the transmission grid and sold on the wholesale electricity market.
98. Unison Networks was granted an exemption from the arms length rule forbidding appointment of managers from the lines business to the board of the joint venture company and allowed to enter into electricity hedges, but required to comply with all the other arms length provisions and may not retail the output from the wind farm to customers on its own network. Eastland Networks' exemption was declined as the Commerce Commission considered that granting it would create incentives and opportunities to inhibit competition, in particular, that Eastland Networks could favour its own retailer over others using its network.
99. The decisions from these exemption applications may provide guidance for future exemptions, decreasing decision-making time. However, in New Zealand, which is a small jurisdiction, it may take a long time for a sufficient number of cases to be

decided to provide a body of case law. This is particularly because we are yet to be convinced that exemptions are likely to be widespread, rather than limited to a few specific cases. However, once a body of cases exist, guidance from these may be more useful than creating an additional set of legislative guidelines.

## **Conclusion**

100. It is unclear the extent to which the exemptions process needs changing. Not many cases requesting exemption for investment in new generation have yet been considered. On balance, the Ministry's recommendation is that any additional criteria would be included as something that may be taken into account, rather than as requirements.

### **4.3.2 Proposed Option – redraft arms length rules to make these more specific**

101. Redraft the provisions of 'arms length' rules in Schedule 1 of EIRA to include more information spelling out what is and is not permitted and description of activity/functions rather than the titles of individuals performing functions.

#### ***Benefits***

102. Some lines companies suggest that more specific wording of the arms length rules in Schedule 1 of EIRA would make it easier for them to know how to meet the requirements of the act and to reduce uncertainty, which would encourage additional investment in generation.

103. This proposal would be consistent with international approaches to this issue. As noted in appendix 3, both Australian and UK rules are much more specific on detail of what is required in order to ensure separation between monopoly and competitive parts of an electricity business. For example, in New South Wales, businesses are required to have physical separation of offices, information separation, and staff separation between lines and supply businesses.

#### ***Costs/Risks***

104. There is a need to consider the balance between being flexible and being specific. If the arms length rules were made more specific, they would also become more prescriptive. This may then also discourage investment in generation if lines companies find difficulties in meeting particular requirements.

105. The questions stakeholders need to consider are firstly whether they consider the costs of uncertainty under the current provisions in schedule one are greater than the costs of complying with more detailed arms length requirements, and secondly which specific areas do lines companies require more certainty in?

## **Conclusion**

106. On balance, the Ministry does not recommend reviewing the provisions of the arms length rules at this stage.

## 5. Summary

107. Several options of how to remove the unnecessary barriers to lines companies' investment in generation have been considered. Table 2 summarises these options and orders them from preferred through to options not recommended at this stage.

**Table 2: Summary of Proposed Options**

<b>Proposal and Recommendation</b>	<b>Objective (Intended benefit)</b>	<b>Risks (Possible detriment)</b>
Allow hedging of financial risks (Preferred option)	Facilitate investment by enabling lines companies to better manage revenue flows from their output. Increase competition in retail market	Low. Lines companies' generation and retail activities are capped at the amount of their own generation.
Remove the requirement for lines companies to comply with arms length rules when generation and customers are outside the lines company network (Preferred option)	Facilitate investment in generation by capturing benefits of lines company knowledge of electricity sector; removing incentives for anti-competitive behaviour on local network	Possible risk of cross-subsidy. However, this risk should be managed through monitoring under part 4A of the Commerce Act.
Provide greater flexibility for lines companies to decide how to implement arms length rules (Not recommended – current exemptions process should take into account situations where lines companies require additional flexibility in ALR)	Facilitate generation investment by reducing administrative costs of compliance with arms length rules	May have very high costs for cases to be decided plus high on-going monitoring costs to ensure compliance
Provide criteria in legislation to guide applications for exemptions from EIRA (Not recommended as compulsory criteria, there may be value in including additional criteria the Commission may take into account.)	Provide a more transparent and timely process for applicants for exemption from the provisions of EIRA	May make process too prescriptive and more difficult to gain exemption. If compulsory criteria may slow exemption applications process.
Make changes to the wording of arms length rules in Schedule 1 of EIRA (Not recommended)	Reduce uncertainty and therefore increase investment	Unclear whether this is actually a problem, more certainty may make rules more prescriptive and discourage generation investment.
Raise the threshold for arms length separation (Not recommended)	Facilitate investment in generation by reducing costs of cross-ownership	Risk of lessened competition through increased opportunity for cross-subsidy and anti-competitive behaviour on local network
Introduce less onerous arms length requirements (Not recommended)		

108. The Ministry considers an ability to trade in hedge and spot energy markets (up to the nominal output of their generating capacity, assuming that it is available on a continuous basis) will be an important aspect in lines companies' investment

decisions. It is also considered to be a necessary step in the effective implementation of the policy decisions taken as part of the 2004 Amendment of the Act. The Ministry is therefore proposing to progress this proposal by recommending a legislation change to the Minister of Energy with the details of the policy to be worked out (in consultation with the industry) once the Government gives a high level policy approval for this proposal.

109. There is a case for removing the arms length rules when generation is connected to an unrelated network. Generation not connected to local networks will capture any benefits of comparative advantage lines companies have in generation investment, while not providing incentives for companies to use their knowledge to behave anti-competitively.
110. The Ministry considers that a separate regime for lines companies to apply for flexibility in the application of arms length rules is not necessary. The current exemptions regime should take into account cases where lines companies are seeking additional flexibility in the application of arms length rules and any new process for assessment would be sufficiently similar to the current exemptions regime.
111. Introducing additional criteria in legislation for the consideration of exemptions is not considered necessary at this stage. Not many cases requesting exemptions for investment in new generation have yet been considered. On balance, the Ministry's recommendation is that additional criteria would be included as something that may be taken into account, rather than must be taken into account.
112. The Ministry does not recommend redrafting the provisions of the arms length rules in Schedule 1 of EIRA at this stage.
113. Raising of the threshold where arms length rules apply to 50MW (i.e removing all statutory constraints on cross-ownership or making changes to the arms length rules to make these less onerous are not considered appropriate at this stage. The Ministry considers that these proposals would have a significant risk of enabling anti-competitive behaviour by lines companies in generation and retail markets. However, the Ministry is evaluating the merits of raising the lower thresholds where arms length rules apply and will consider submissions addressing this issue.
114. The Ministry, however, recognises that in some instances, the cost of compliance may outweigh the benefits. In these situations, lines companies are encouraged to seek exemption under s 81 of the Act. Since the introduction of the Act, the Commerce Commission has considered a limited number of exemptions and a significant increase in the number and similar nature of the granted exemptions could warrant a review of aspects of the legislation in the future.

## 6. Expressing Your Views

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The Ministry of Economic Development would welcome comments on this paper by 25 May 2006.

Your comments and suggestions are sought on all the aspects of this paper.

Please send your comments and suggestions to:

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Email: [electricity@med.govt.nz](mailto:electricity@med.govt.nz)

Please note that your submission will become public information and therefore accessible to general public according to the terms of the Official Information Act 1982.

Please indicate clearly if your comments are commercially sensitive, or if, for some other reason, you consider they should not be disclosed under the Official Information Act 1982. Any request for non-disclosure will be considered in terms of the Official Information Act 1982.

# **Appendix 1: The Ministry's Response to the Key Issues Raised in Submissions on March 2005 Discussion paper**

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1. Lines companies have, by and large, argued that an ability to trade in spot and hedge markets is a necessary but not in itself sufficient condition to remove barriers to their investment in generation. Many have stated that the current requirements for the corporate separation and arms length rules are by far much bigger barrier to their ability to investment, hence, if relaxed, would be sufficient to induce their entry into the generation market.
2. Some generators/retailers have expressed strong views against the proposal, viewing it as contrary to the original policy intent of EIRA, and therefore argued for a review of changes to the Act to ensure these are not made piecemeal.
3. Key issues raised in the submissions and the Ministry response to these issues are outlined below.

## **POLICY OBJECTIVES**

### **Submissions**

4. The proposed amendment has been perceived as an incremental policy proposal, which contradicts the original policy intent of the Act. It was suggested that New Zealand's electricity sector will be better served by a first principles review of the policy objectives with respect to the role of lines companies in the sector, followed by an establishment of a clearer policy framework for the distribution sector.

### **The Ministry Response**

5. The Ministry considers that merits and ramifications of the policy to relax the original cross ownership provisions of the Act to allow lines companies limited involvement in the generation and retail markets have been widely debated as part of the 2001 and 2004 Amendments of the Act.
6. The outcomes of this debate were decisions to relax the original cross ownership provisions of the Act. Since the passage of the recent legislative amendment, it has become clear that these relaxations have little practical effect without the ability of lines companies to manage the risks associated with selling the output from their generation. The Ministry therefore considers that the proposal to allow lines companies to trade in hedge and spot energy is simply a means of achieving effective implementation of the policy decisions taken as part of the 2004 Amendments.

## **PROPOSED HEDGING LIMITS**

### **Submissions**

7. The proposed limits are too generous as they take no account of the generating plant's capacity factor and may result in lines companies being able to sell more electricity than they generate. Others suggested that the proposed limits are too

restrictive and unnecessary as the risk of over or under hedging is better managed by investors rather than regulators.

### **The Ministry Response**

8. The Ministry is of a view that the proposed limits strike a reasonable compromise, which allows a generation plant to be fully hedged while the simplicity of regulation is maintained.

### **Submissions**

9. Lines companies should be allowed to trade in financial instruments to support planned generation plant of up to the current limits of 50 MW or 20% of peak load (and unlimited for renewables), provided that firm contracts with purchasers are in place for the quantities of energy being hedged.
10. This limit should be reviewed in 5 years time with a view of removing it completely if the Government's desired outcomes have been achieved.

### **The Ministry Response**

11. The proposal aims to facilitate investment in new generation. The proposed modifications appear to be focused more on building a retail business. This is not the purpose of the proposal.
12. The proposed limits can be reviewed at any time, subject to the requirement for a specific review.

## **STATE OF THE HEDGE MARKET**

### **Submissions**

13. The thinness of New Zealand's electricity hedge market makes it difficult to obtain hedges, and is therefore an impediment to an effective implementation of the proposed amendment.

### **The Ministry Response**

14. The Ministry recognises that an effective hedge market is a key to effective implementation of the proposed amendment. The development of a liquid and transparent hedge market in New Zealand is one of the key priority areas in the Electricity Commission's work programme and is being worked on accordingly.

## **THE PROPOSAL IS PREMATURE**

### **Submissions**

15. Consideration of the proposal should be deferred until the Electricity Commission completes its work programme on barriers to entry and the development of the hedge market and the Commerce Commission completes its study of competition in the market.

## **The Ministry Response**

16. The Electricity Commission work programme is broad and designed to improve market conditions in general, whereas the proposal in question is a very specific initiative designed to remove specific barriers to the successful implementation of policy decisions taken as part of the 2004 Amendment Act.

## **RELEVANCE TO OTHER INVESTORS**

### **Submissions**

17. Barriers to investment cited by lines companies are present for all potential entrants to the generation market. Hence the appropriateness of making lines companies a specific target for intervention was questioned.

### **The Ministry Response**

18. The proposal focuses on barriers faced by lines companies because it aims to ensure that policy decisions taken as part of the 2001 and 2004 Amendments of the Act can be effectively implemented.

## **CLARIFICATIONS REQUIRED**

### **Submissions**

19. The proposal seemed to be interpreted as requiring lines companies to wait for the generation to come on-line before a hedge contract could be negotiated and signed.

### **The Ministry Response**

20. This was not the intention. The Ministry's view is that lines companies should be able to negotiate and sign hedge contracts on the basis of expected future generation capacity. The objective is to ensure that the contracts do not come into effect prior to the generation capacity becoming available.

### **Submissions**

21. A question as to whether the proposed limits would apply to both selling and buying of hedges was raised in the context of the current legislative provisions not restricting lines companies' ability to buy hedges.

### **The Ministry Response**

22. The focus of the proposal was on the trading activity, rather than on buying and selling of hedges per se. The current legislative restriction on selling (but not buying) of hedges was considered to be sufficient to prevent any trading activities. Any further amendment is likely to follow similar approach.

### **Submissions**

23. A question as to whether the proposal would apply to both continuous generation and peak plant generation was raised.

## **The Ministry Response**

24. The proposal is intended to apply to both continuous generation and peak plant generation.

## **MONITORING ARRANGEMENTS**

### **Submissions**

25. It was recommended that the Ministry adopts a simple audited reconciliation from the lines companies confirming that the value of the financial instruments other than FTRs (as these are also called financial instruments) sold over a calendar year, do not (on average over the 12 months period) exceed the specified limits.
26. Another suggestion was to require monthly reports by lines companies.

### **The Ministry Response**

27. The Ministry is in favour of a simple auditing mechanism and will work with the Commerce Commission to determine effective and efficient monitoring options.
28. It is likely that an annual audit would be sufficient. Such an audit would ensure that a lines company's net hedging position did not at any time exceed the specified limit. In other words, it is proposed that a contract portfolio would be seen as compliant with the limits provided that the net quantity sold over 12 months did not exceed the allowed limit during any trading interval over that period.

## Appendix 2: List of Submitters

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**Submitter:**

[Top Energy](#)

[Aurora Energy Limited](#)

[Northpower Network](#)

[Bryan Leyland](#)

[Eastland Infrastructure](#)

[Electricity Ashburton](#)

[Contact Energy](#)

[Genesis Power Limited](#)

[Unison](#)

[Meridian Energy](#)

[Electricity Networks Association](#)

[Powerco](#)

[Orion Group](#)

[Network Tasman Limited](#)

[Counties Power](#)

[WEL Networks](#)

[Major Electricity Users' Group](#)

[Vector Limited](#)

[Mighty River Power Limited](#)

[Mainpower](#)

Westpower (late submission, not published on the website)

## Appendix 3: Examples of International Approaches to Regulation

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1. In the United Kingdom, under the Utilities Act 2000, electricity supply and distribution activities are separate licensable activities, with a bar on the same person holding both an electricity supply and an electricity distribution licence<sup>6</sup>. The standard Licence Conditions for Electricity Distribution Licences<sup>7</sup> specify restrictions on the use of certain information and independence of the distribution businesses. Any information in relation to management and operation of the distribution business is to be treated as confidential. To facilitate compliance with this requirement, the licensee is required to “...establish and ...maintain the full managerial and operational independence of the distribution business ...from each other business ...of the licensee and of its affiliates and related undertakings”<sup>8</sup>.
2. Other requirements include:
  - no access to premises, data systems, equipment, facilities or property used for the distribution business by any other business of the licensee.
  - People who are no longer engaged in the management and operation of the distribution business are not allowed to be engaged in any other business of the licensee for at least 3 months.
  - A statement must be prepared and kept up to date setting out practices, procedures and systems which the licensee has adopted to ensure its compliance with the relevant duties. The statement, and its updates, must be approved by the regulator (Ofgem)<sup>9</sup>.
  - Cross-subsidisation between the businesses of the licensee or of an affiliate or related undertaking of the licensee is also prohibited.
3. In several Australian states, such as Queensland and New South Wales, ring-fencing of network service providers has been introduced to ensure that businesses operating in regulated monopoly industries do not use their monopoly positions to influence outcomes in unregulated competitive markets<sup>10</sup>.
4. The framework under which New South Wales operates has three features<sup>11</sup>:
  - A high level statement prohibiting anti-competitive conduct
  - A set of detailed, activity-focused default ring fencing guidelines; and
  - A mechanism whereby the distributors could seek to alter the guidelines.
5. The guidelines require the distributor to:

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<sup>6</sup> [http://www.dti.gov.uk/energy/gas\\_and\\_electricity/regulation\\_policy/licences/sep\\_supply\\_dist.shtml](http://www.dti.gov.uk/energy/gas_and_electricity/regulation_policy/licences/sep_supply_dist.shtml)

<sup>7</sup> [http://www.dti.gov.uk/energy/gas\\_and\\_electricity/regulation\\_policy/licences/sc1\\_elecdist.pdf](http://www.dti.gov.uk/energy/gas_and_electricity/regulation_policy/licences/sc1_elecdist.pdf)

<sup>8</sup> Para 5 of the condition 39.

<sup>9</sup> <http://www.ipart.nsw.gov.au/documents/RINGFENCINGOFNEWSOUTHWALESELECTRICITYDISTRIBUTIONNETWORKSERVICEPROVIDERSDISCUSSIONPAPERANDDR.PDF>

<sup>10</sup> <http://www.ipart.nsw.gov.au/documents/RINGFENCINGOFNEWSOUTHWALESELECTRICITYDISTRIBUTIONNETWORKSERVICEPROVIDERSDISCUSSIONPAPERANDDR.PDF>

<sup>11</sup> <http://www.ipart.nsw.gov.au/documents/RINGFENCINGOFNEWSOUTHWALESELECTRICITYDISTRIBUTIONNETWORKSERVICEPROVIDERSDISCUSSIONPAPERANDDR.PDF>

- Provide distribution services and information related to independent service providers on terms no less favourable than the terms on which service is provided to the parts of the business which provide contestable service
  - Allocate costs between monopoly and contestable activities on the basis of relevant, reliable and verifiable factors
  - Let customers know that there is a choice of providers of contestable services
6. There are rules in the guidelines applying to operational tasks (for example, construction and inspection), i.e. functional separation. These include physical separation of offices, information separation, and staff separation.
7. The default guidelines are compulsory unless the regulator agrees to modify or waive them. However, the regulator recognises that the impact of ring fencing guidelines will differ depending on the circumstances of each individual firm. Distributors can therefore suggest alternative measures to those set out in the default ring fencing guidelines. The regulator will allow firms to adopt these measures if it considers the alternative approach will meet ring fencing objectives. Other stakeholders, such as customers or competitors are also permitted to seek to modify or add to ring fencing obligations of distributors in cases where existing guidelines did not provide adequate protection against certain forms of anti-competitive conduct.
8. The regulator assesses each proposed change against pre-established guidelines, which provide transparency and guidance for potential applicants. To decide whether or not to grant a waiver the regulator must conduct appropriate public consultation and may have regard to:
- the administrative costs of compliance for the distributor
  - the distributor's ability to achieve economies of scale;
  - the size of the relevant market;
  - the extent to which competition will be diminished or enhanced if the waiver is granted or refused; and
  - any other factors considered relevant.
9. Ring-fencing rules in Queensland have a similar objective: "...to assist in creating an environment where the price, quantity and quality of electricity traded in the retail market, and the price, quantity and quality of distribution services used to deliver the energy, are not uneconomically biased by the vertical integration of distribution and other businesses"<sup>12</sup>. The guidelines are based on legislation that already requires legal separation between distribution and retail activities. In summary, the guidelines require a distributor to:
- not carry on a supply business within that legal entity;
  - establish and maintain a separate set of accounts for the distribution services;
  - allocate any costs shared between a distribution activity and any other activity, in a way that ensures there is no cross subsidy;

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<sup>12</sup> <http://www.qca.org.au/files/ACF187C.pdf>

- ensure all confidential information provided by customers is used only for the purpose for which it was provided and is not disclosed without the approval of the customer or prospective customer who provided it:
  - ensure all confidential information which might reasonably be expected to affect materially the commercial interests of a customer or prospective customer is not disclosed to anyone without the approval of that customer
  - ensure that its marketing staff are not also staff of an associate that takes part in a related business.
10. A distributor is exempt from complying with some of the above if the arrangements under which it shares staff or if the information obtained by the distributor is disclosed to its staff in a manner consistent with protocols prepared by the distributor and approved by the regulator.
  11. The regulator may require the distributor to comply with obligations in addition to the minimum obligations outlined above or add to or amend these Distribution Ring-Fencing Guidelines, provided that it is satisfied the distributor cannot demonstrate that the administrative cost to the distributor and its Associates of complying with the additional or altered obligations is, or is likely to, outweigh the benefit to the public.
  12. The regulator may waive any of a distributor's obligations provided that the regulator is satisfied that the distributor can demonstrate that the administrative cost to the distributor and its Associates of complying with the obligation outweighs the benefit, or any likely benefit, to the public. A distributor must apply to the regulator for a waiver from obligations. When the regulator receives an application it must either:
    - reject the application without further consideration if it considers that the application has been made on trivial or vexatious grounds; or
    - in all other cases, within 14 days after receipt of the application, inform each person known to the regulator who the regulator believes has a sufficient interest in the matter that it has received the application by publishing a notice in a national daily newspaper and request submissions by a date specified in the notice.
  13. A distributor must provide a report to the regulator, at reasonable intervals determined by the regulator, describing the measures taken to ensure compliance with its obligations under these Guidelines. This report, along with the regulator's assessment of compliance, is then made public. The regulator may, upon reasonable notice, require a distributor to appoint an independent auditor approved by the regulator to report on such matters.
  14. From these examples we can see that other countries also have additional electricity industry specific guidelines separating different parts of the electricity sector, in addition to general competition legislation. For example, Australian states' ring-fencing guidelines impose similar requirements to New Zealand's arms length rules, and in the United Kingdom distribution and generation companies are separately licensed and need to meet specific requirements (with ongoing monitoring) to maintain their licence. So it is clear that other countries also are of the view that trade laws by themselves are not sufficient to prevent cross-subsidies and other monopolistic practices when companies that are natural monopolies enter a competitive part of the electricity market. New Zealand's requirement for arms length separation is in fact broadly consistent with regimes applied in other jurisdictions.