

25 May 2006

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Ministry of Economic Development  
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Dear Janet

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

- 1 Orion New Zealand Limited ("Orion") welcomes the opportunity to make this submission in response to the Ministry's "Investment in Electricity Generation by Lines Companies" discussion paper ("the Paper") of April 2006.

#### **Executive summary**

- 2 In this submission, we state the case for the adoption of what we consider to be the central proposal of the Paper, namely that distributors be entitled to own distributor generation up to the greater of 50MW or 20% of maximum demand and to sell their output, without the need to comply with cross-ownership rules under the Electricity Industry Reform Act 1998 ("EIRA").
- 3 This proposal is pro-competitive because: (a) it promotes security of supply, (b) it promotes competition for generation/retail, and (c) it results in more efficient utilisation of distribution networks.
- 4 The perceived anti-competitive concerns surrounding distributor generation are misplaced. We address all of the competition concerns which have been put forward by the Ministry and the Commerce Commission. The central points to emerge from this analysis are:
  - Distributors are already exposed to regulatory and competition law regimes which provide real avenues for control and redress. These regimes have evolved since the EIRA was promulgated in 1998.
  - Government has the legislative power to provide greater prescription of rules. This threat is very real and immediate, as recently demonstrated by the decision to unbundle Telecom's local loop.
  - To the extent that distributors have market power, they are constrained by the price control regime under Part 4A of the Commerce Act. It therefore cannot be

assumed that distributors have power at any level of the market which enables them to earn monopoly rents.

- It follows that (a) access to distributor networks is likely to be non-discriminatory; (b) cross-subsidisation is unlikely to occur; and (c) any attempt to engage in anti-competitive conduct will be risky, and subject to corrective outcomes under the existing regulatory and legislative regimes.
- 5 Distributor generators will need to be entitled to trade in financial instruments up to the nominal generation capacity of plant on a continual basis in order to support supply contracts with customers.
- 6 We set out below our reasons for these conclusions.

## **Outline**

7 This submission is in three main parts as follows:

a. Goals:

The first part provides a brief comment on the background goals which justify further liberalisation of distributor generation. This section also identifies what we consider to be the central proposal of the Paper.

b. Issues requiring further consideration:

The second part identifies the main issues raised by the Ministry which need to be addressed in order to achieve increased distributor generation.

c. Answers and solutions:

The final part sets out what we consider to be the answers and solutions to these matters requiring further consideration, in the context of the current consultative round.

## **Goals**

- 8 When first enacted, EIRA prevented distributors from engaging in generation. That prohibition has been progressively relaxed in the 2001 and 2004 Amendments to EIRA.<sup>1</sup> In particular, these reforms entitled distributors to own distributor generation up to the greater of 5MW or 2% of their maximum demand and to sell their output, without the need to comply with the original EIRA cross-ownership rules (including corporate separation and arms length requirements.)
- 9 The reasons for this change in policy included:
- a. The promotion of the security of supply of electricity;
  - b. The promotion of competition in the generation market; and
  - c. The efficient utilisation of distribution networks where, for example, it is more economically efficient to develop distribution generation than it is to undertake network upgrades.

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<sup>1</sup> The relevant legislative developments in this context are set out in para 2.1 of the Paper.

- 10 These reasons, coupled with the potential for enhancement of competition in the retail market, provide a continuing justification for the central proposal considered in the Paper, namely that the threshold for arms length separation should be increased from the current level (the greater of 5MW or 2% of maximum demand) up to the current cross-ownership limits (being the greater of 50MW or 20% of maximum demand<sup>2 3</sup>).
- 11 While our comments in this submission are limited to this central proposal, we should add that the analysis set out below also justifies the further raising of the threshold level for arms length separation beyond the greater of 50MW or 20% of maximum demand. There is no reason to assume that this proposed extension to the threshold sets an appropriate limit.<sup>4</sup> In practice distributors will be constrained by commercial and risk considerations on the size and amount of generation investment contemplated. There are a variety of potential opportunities for distributors to make valuable contributions to the generation mix in New Zealand. These opportunities will depend to a great extent on regional (fuel) resources and the extent to which transmission or distribution capacity constraints are present. For example a wind generation scheme may be viable in a certain region if backed up with thermal or hydro generation. We would welcome the opportunity to engage in further dialogue on this point, and invite the Ministry to take this matter into account in the current submission round. It would be unfortunate if sound economic schemes were unable to proceed because of an arbitrary limit.
- 12 Orion is well positioned to respond to the goal of increased distributor generation. We have investigated the use of approximately 30MW of diesel generation for providing “reserve energy” to the Electricity Commission and for peak control to avoid transmission upgrades. We have the necessary resource consents to allow generation up to 43MW. We have not proceeded, in part, due to the current limitations contained in the EIRA. Orion is also keen to ensure the development of other generation options within Orion’s network area in order to defer network and transmission investment. This generation would also provide greater levels of network security by mitigating against network interruptions. We consider that if distributors were able to engage in distributor generation up to and beyond the proposed new threshold level (the greater of 50MW or 20% of maximum demand), this would also enhance retail competition.

### Issues requiring further consideration

- 13 The Paper reveals that there are three main issues which require further consideration before it may be possible to achieve distributor generation up to the current cross-ownership limits just noted above. These are:

- a. Governance issues:

For projects of the kind in question (generation up to the greater of 50MW or 20% of maximum demand), arms length separation rules are a barrier to expansion. There is no viable business case in this context which justifies separate boards or management. Further, it would be problematic from a governance point of view

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<sup>2</sup> We understand this consultative round to be in the context of an evolving assessment of issues around distributor generation. As the Paper notes at paragraph 38, there is the potential for further assessment of this issue following the completion of the current inquiry by the Commerce Commission and the Electricity Commission into the level of competition in the generation and retail markets. For this reason, we limit our submissions to the matters put forward in the Paper.

<sup>3</sup> Our focus is upon the relaxation of limits upon distributor generation without limitation as to the location. For this reason we make no submissions on the proposal that arms length rules should be removed where generation is connected to unrelated networks: paras 78-84 of the Paper. Nonetheless, we record our agreement with the Ministry’s conclusion in this section of the Paper, namely that there is a case for the removal of such rules.

<sup>4</sup> It is not clear why this particular generation capacity has been set, it appears purely arbitrary and has arisen presumably to try and manage some perceived negative impact on the market of allowing distributors to be involved in generation and associated activities.

for the board of Orion to make an investment decision in favour of a subsidiary in respect of which they have no control or influence. Good governance, and the efficient operation of Orion, requires that there be common directors and management between Orion and any generation subsidiary.

b. Trading in financial instruments:

The current prohibition on the hedging of financial risks is also a barrier to expansion in distributor generation.

c. Addressing perceived competition law concerns:

The Ministry reaches adverse conclusions about the potential competitive behaviour of lines businesses in respect of the proposal for the raising of the threshold for arms length separation.<sup>5</sup> These concerns mirror the competition concerns which the Commerce Commission has expressed in relation to the proposed supply by distributor generators into the retail markets serviced by their lines business.<sup>6</sup>

## Answers and solutions

### Governance issues

- 14 The Paper notes the governance concerns we have addressed above,<sup>7</sup> but does not provide any detailed discussion on the subject. We assume that the Ministry appreciates and accepts the commercial logic that we have described above relating to distributor generation investment decisions. We believe that additional distributor generation (up to the greater of 50MW or 20% of maximum demand) will not come to market unless there is further relaxation of arms length rules.
- 15 The governance concerns we have described above would be remedied by an amendment to section 5(2)(e) of EIRA, by substituting the 5MW and 2% of maximum demand thresholds with 50MW and 20% maximum demand thresholds respectively.

### Trading in financial instruments

- 16 The Paper correctly recognises that distributor generators will be hindered in their ability to sell electricity under continuous supply contracts to retail customers, unless they are able to trade in financial hedges and related instruments.<sup>8</sup> If generator distributors are entitled to trade in financial instruments up to the nominal generation capacity of plant on a continual basis, then this will serve to potentially enhance competition in the retail market.
- 17 Again, given the coverage of this topic and the conclusions reached in the Paper, we do not think it necessary to say more on this point. This matter can be remedied by an amendment to section 5 of EIRA.

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<sup>5</sup> Para 57-63 of the Paper.

<sup>6</sup> See Eastland Networks Limited, Decision 575. In contrast, the Commission has held such retail market concerns do not arise where the distributor generator proposes to inject output into the national grid: see Unison Networks Limited, Decision 576.

<sup>7</sup> Para 33.

<sup>8</sup> As we outlined in paras 16-18 of our submission of 18 April 2006, distributors will need to be able to buy electricity on the spot market to cover periods where own generation is unavailable.

## Competition law concerns

- 18 The Ministry correctly recognises that increasing the threshold for arms length separation up to the greater of 50MW or 20% of maximum demand will be pro-competitive.<sup>9</sup> Additional competition in retail is likely. The further pro-competitive goals which underpinned the 2001 and 2004 Amendments to EIRA will also be served by this increase in the threshold. In addition to the promotion of competition at generation/retail, distributor generation will serve to secure supply. A further pro-competitive goal is that distributor generation will aid in the efficient utilisation of networks, as we have already noted.
- 19 The Ministry's countervailing competition concerns<sup>10</sup> appear to be in alignment with the Commerce Commission's competition concerns, as most recently articulated in the *Eastland Networks* decision. These concerns of the Ministry and the Commission can be summarised as follows:
- a. *Price discrimination*: distributors will be able to charge more to competitor retailers than they will charge themselves;
  - b. *Cross-subsidisation*: distributors will be able to cross-subsidise their retailing businesses from their lines businesses;
  - c. *Gaming*: distributors will be able to game against competing retailers (eg delaying or inhibiting access to lines, giving preferential treatment to their own retail customers, providing slower lines connections to non-retail customers, and providing differential treatment in relation to outages);
  - d. *Information advantage*: distributors will have information about the best customers on the network;
  - e. *Preventing customer transfer*: there is the suggestion that distributors may, to the extent possible, prevent customer transfers;
  - f. *Deterring new entry to generation*: potential new entrants would be required to reveal commercially confidential plans to distributors (who will also happen to be competitor retailers); and
  - g. *Enforcement problem*: behavioural regulatory solutions are difficult, costly and an "uphill battle" for the regulator.
- 20 In our opinion, neither the Ministry's Paper, nor the *Eastland Networks* decision, clearly articulates or appreciates the nature and extent of the regulatory constraints, and other competitive influences, which are now imposed upon distributors. In the remaining parts of this submission we:
- a. Outline the regulatory landscape which now applies to distributors; and
  - b. Answer each of the Ministry's (and the Commission's) competition law concerns which we have just noted above.

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<sup>9</sup> Paras 54-56 of the Paper.

<sup>10</sup> Paras 57-63 of the Paper.

## Regulatory landscape

- 21 The landscape facing distributors today has evolved since the EIRA was first designed in 1998, and includes the following:
- a. *Information disclosure*: section 57T of the Commerce Act requires distributors to disclose wide-ranging information, including prices and pricing methodologies, returns, valuations, related party transactions and contracts (including terms and conditions of supply). These disclosures provide significant detail of both revenue requirements and cost allocations across customer groups.
  - b. *Price control*: distributors' prices are essentially regulated under the threshold and breach regimes of Parts 4A and V of the Commerce Act. Since 2001 the Commission has been giving effect to a regulatory regime which has, as a central goal, the extraction of excessive profits - should they exist. Therefore, a regime has evolved whereby it cannot now be assumed that distributors are making monopoly rents; nor do distributors have the ability to unilaterally increase price without regulatory consequences.
  - c. *Access regulations*: draft regulations, pursuant to the 2001 Amendment to the Electricity Act, have been under discussion for a considerable length of time and we believe that they are now well advanced. These regulations will ensure that generators (including new entrants) do not face barriers (price or non-price) pertaining to access to distribution. The proposed access regulation, as described in the Ministry's "Facilitated Distributed Generation" discussion paper (September 2003), anticipates that:
    - i. Applications will be processed within 20 working days for distributor generation less than 10kW, three months for generation 10kW to 3MW, and four months for generation over 5MW;
    - ii. Standard connection contract terms and conditions will be publicly available;<sup>11</sup> and
    - iii. When terms and conditions of connection are not agreed or a connection application is declined, either party may refer the matter to arbitration, which arbitration must be completed within three months.
  - d. *Electricity Governance Regulations and Rules*: the Electricity Commission's principal objective, as set out in the Electricity Act, is to ensure that electricity is produced and delivered to all classes of consumers in an efficient, fair, reliable and environmentally sustainable manner. The Commission is also required to promote and facilitate the efficient use of electricity. To meet these objectives the Commission has developed rules as follows:
    - i. Part D of the rules sets out obligations in relation to metering standards; and
    - ii. Part E of the rules provides for the management of information held in the registry<sup>12</sup> and a process for switching customers between retailers.

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<sup>11</sup> This discussion paper also outlines principles to be taken into account in relation to the connection contracts. Various pricing methodologies are set out which will ensure that distributors will not be able to impose unjustified costs or payment methodologies upon generators/retailers. For example, it is proposed that: (a) for purpose built distributed generation, a reasonable annual connection operating fee to cover ongoing administration and maintenance of assets associated with distributed generation, may be charged, but this fee may be no greater than 5% of any similar charge to an electricity customer; and (b) a distributed generator greater than 10 kW should receive 85% of the benefits a lines company derives from the distributed generation reducing transmission costs.

In addition, Orion also belongs to the Electricity Complaints Commission scheme which provides an avenue for customer complaints to be heard independently and at no cost to the customer.

- e. *Monopolisation laws*: the behavioural constraint imposed by section 36 of the Commerce Act is not recognised or considered by the Ministry and the Commission in the Report or the *Eastland Networks* decision. The recent decision of the High Court of Australia in *NT Power Generation Pty Ltd v Power and Water Authority* [2004] HCA 48 serves to demonstrate the relevance of section 36 to the present setting. Distributors will be at real risk of breaching section 36 if they act anti-competitively, in light of this decision. Courts will be likely to infer that distributors have taken advantage their market power where there is any evidence of an anti-competitive purpose, coupled with relevant conduct.<sup>13</sup> Accordingly, the conduct of distributors will be significantly conditioned by the potential for a violation of section 36.

## Answers to the competition law concerns

### 22 Price discrimination:

The disclosure requirements imposed on distributors ensures that there will be transparency in pricing. Generators/retailers and regulators will therefore be aware of any price discrimination between distributors and generators/retailers who access their network. This will serve to deter price discrimination. Further, there are other safeguards against anti-competitive price discrimination:

- a. There is legislative power to provide greater prescription of rules. This threat is very real and immediate, as recently demonstrated by the decision to unbundle Telecom's local loop.
- b. Further, there is the real risk that anti-competitive price discrimination would be in breach of section 36 of the Commerce Act. The Commerce Commission has powers, under the cease and desist order regime provisions,<sup>14</sup> to achieve timely resolution of anti-competitive price discrimination. The Commission can seek an order to restrain a distributor from engaging in price discrimination, where such pricing conduct is directed at preventing, deterring or eliminating competition from generators/retailers. On the basis of the approach taken in *NT Power*, as noted above, distributors will, in the absence of any legitimate justification for the discrimination, have difficulty in resisting the inference that anti-competitive terms and conditions of access will amount to the taking advantage of market power for the purposes of section 36.

### 23 Cross-subsidisation:

It is not sound to assume that distributors will be able to cross-subsidise their retailing business from their lines business and in so doing threaten or harm other retail competitors for two main reasons:

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<sup>12</sup> The registry is the database that identifies every point of electricity connection using an installation control point (ICP) reference, enabling energy flows between retailers to be reconciled. The registry also informs retailers when a customer switches supplier.

<sup>13</sup> The purposes prohibited by section 36 include conduct for the purpose of (a) restricting new entry, (b) preventing or deterring competition or (c) eliminating competition. In *NT Power* the Court used as its counterfactual a hypothetical competing lines network with spare capacity, granting access on reasonable terms and conditions, as the terms of reference leading to the finding that there had been a taking of an advantage of market power. It can be anticipated that this counterfactual will be adopted in future cases and this approach will make it difficult for distributors to defend anti-competitive behaviour under section 36.

<sup>14</sup> Sections 74A to 74D of the Commerce Act.

- a. This theory assumes that distributors are earning monopoly rents for lines business services. This assumption cannot be made now that distributors are subject to the price control regime of Part 4A of the Commerce Act. Since 2001, the Commerce Commission has put in place, and is giving effect to, a regime which ensures that distributors are not able to extract excessive profits.
- b. Further, even if it was possible for anti-competitive cross-subsidisation to occur, this coupled with predatory conduct in the retail market would also be actionable under section 36.<sup>15</sup>

## 24 Gaming:

Orion considers that the perception of the possibility of distributors gaming is overstated for a number of reasons:

- a. As noted above, distributors are governed by the Electricity Governance Regulations 2003 and the Electricity Governance Rules. Additionally, the industry has developed the Electricity Complaints scheme which is continually evolving. These various regulations and rules have a wide range of requirements relating to customer interaction. The Electricity Commission's registry is designed to provide a mechanism to facilitate customer switching, while the Electricity Complaints Commission scheme provides an avenue for customer complaints to be heard independently.
- b. Market realities also serve to answer gaming stories.

*Providing differential treatment to customers in relation to outages*

The very nature of an interconnected network prevents distributors providing differential treatment to customers in relation to outages, as following an outage power is restored to many customers (often hundreds of customers) simultaneously. Further, history demonstrates that there has not been gaming around restoring outages. Notwithstanding incentives under SAIFI and SAIDI to restore one group of customers over others, it has not been Orion's experience that this has resulted in preferential treatment being given to any given class of consumers.

*Giving preferential treatment to their own retail customers, by providing slower lines-connections to other retail customers.*

Lines companies have processes in place relating to new connections which would apply to all customers. In Orion's case our business process includes:

- i. publishing a time frame that outlines how long it will take to get connected
- ii. provision that the customer or any person authorised by the customer may fill in the application form

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<sup>15</sup> It is true that a predatory pricing action may be more difficult to establish under section 36, than the other situations in this submission where we say that section 36 will have a significant constraining effect on market behaviour. It appears that for section 36 to apply in the predatory pricing situation, it would need to be established that there is below-cost pricing with a view to recouping the costs of this later on, without fear of reprisals: *Carter Holt Harvey* (2004) 11 TCLR 200, para 60. However, we repeat that it will not make commercial sense for a distributor to pursue a path of cross-subsidisation when it is unable to earn monopoly rents in the only market in which it holds market power.

- iii. assigning to applicants a reference number which provides a record to the contract manager assigned to facilitate the connection
- iv. an approach which gives people a choice of designer and electrical contractor. Orion does not build new connections to its network rather it facilitates the construction of the supply between the existing network and the point where the customer's service main connects to Orion's Network (the Network Connection Point.) It is up to the owner of the premise to ensure the supply from the Network Connection Point to the building and the building's electrical installation is completed and receives a Certificate of Compliance.

*Providing preferential treatment of new connections or using information to become the retailer*

We believe that if this type of behaviour were to occur it could easily be picked up from the monthly statistics that the Electricity Commission publishes based on the data held on their registry. These statistics identify on a monthly basis: the number of ICP's in a network area, the retailer market share by ICP, the incumbent retailers market share of ICP's by network area, customer switches by network area, the retailer market share by volume.

- c. The potential for gaming will also be curbed by the regulatory and competition law threats we discussed above in relation to price discrimination. If distributors do not provide distribution on competitive terms and conditions, as might be expected in a hypothetically competitive distribution market, then the Commerce Commission and the courts will be able to infer a breach of section 36, based on the approach taken in *NT Power*.

25 Information advantage:

Orion also considers that this concern is overstated. In general, it is the incumbent retailers who have the information advantage about customers. In any event, the nature of the market is such that information about customers does not act as a barrier to entry or expansion. It is not difficult for any generator/retailer to discover the relevant information.

26 Deterring new entry in generation:

The concern raised by the Ministry in this context is that new entrants will need to disclose confidential plans to distributors who will also happen to be competitors at generation/retail. On closer examination, this concern is not real in the present context. As we have already noted, the environment exists for new entrants to expect that (a) they will have the ability to gain non-discriminatory access to distributor networks and (b) there are no apparent barriers to customer switching. Further, new entrants will be investing in infrastructure that does not run the risk of asset stranding in the event that any given customers are targeted and lost to the new entrant. In some cases new entrants may be required to contribute to network upgrade costs to support new entry. However, these upgrade costs will not act as a barrier to entry because such entry will be supported by cornerstone contracts.

27 Enforcement problem:

It is true that regulatory solutions do not occur instantaneously. However, as discussed above, there is reason to believe that governmental regulatory responses and the Commerce Commission's cease and desist regime, will provide timely solutions. It would be short sighted to attach too much weight to perceived enforcement problems. These concerns are offset by the pro-competitive impacts that will result if significant distributor generation is brought to market. Such developments will (in accordance with the goals of the 2001 and 2004 amendments to EIRA) promote security of supply, promote competition at generation/retail, and will aid the efficient utilisation of distribution networks.

Yours sincerely

A handwritten signature in black ink, appearing to be 'R. Sutton', written in a cursive style.

Roger Sutton  
**Chief Executive Officer**