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POWERFUL REFORM: RESTRUCTURING THE NEW ZEALAND ELECTRICITY INDUSTRY

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ABSTRACT

The electricity industry in New Zealand has undergone continual evolution since the corporatisation of the New Zealand Electricity Division of the Ministry of Energy in 1987.

The object of this paper is to weigh the rationale for, and the results of the State sector economic reforms of the 1980s, and the effect of competition law in New Zealand, against the policy reasons behind, and the potential impact of, our most recent electricity reform: the Electricity Industry Reform Act 1998.

The paper concludes that the structural changes imposed on the electricity industry by the forced ownership separation of electricity lines businesses and electricity supply businesses, are largely consistent with the pursuit of rationalisation, efficiency and competition, backed by the constraints of the Commerce Act 1986.

However, while the Electricity Industry Reform Act 1998 does not impose traditional "heavy-handed" regulation on the industry, in the sense of consistent government intervention through price control, it does allow the government to interfere in an unprecedented and drastic manner in the private property rights of businesses and investors in the electricity industry. It is submitted that the Electricity Industry Reform Act has effectively created a new form of "heavy-handed" regulation, which is likely to be the focus of much academic debate, and also the potential focus of considerable litigation, as power companies are forced to divest their assets and undergo severe value losses.

The text of this paper (excluding contents page, footnotes, bibliography and annexures) comprises approximately 17,000 words.

I INTRODUCTION

Modern industrial society functions with the expectation that electricity will be available when required. The New Zealand electricity industry has undergone a continuous transformation from 1987 to the present to ensure that this expectation is met, with the ultimate goal of lower costs for customers.

The most recent reform of the electricity industry, the Electricity Industry Reform Act ("the Act"), was passed on 3 July 1998. It was driven by the government's concern with the anti-competitive practices and uncompetitive prices arising from vertically integrated electricity monopolies. This Act has taken a nuclear bomb approach to the industry, setting in place the means for destruction of all of the structures in place at 23 June 1998. In general terms, the Act requires energy companies to undertake an ownership split of their lines business and their energy business. Two options are given; either a mirror trust option or a full sale option with a transitional corporate split requirement. At the generation level of the industry, the Act breaks up the State generator ECNZ, to create four generating entities, each with an ability to supply energy at the retail level.

Arguments have been raised by the Act's numerous detractors that it is "an example of heavy-handed State intervention of a kind not seen since the days of Muldoonism",[1] strong criticism indeed. The purpose of this paper is to describe and analyse the policy behind the regulation of the electricity industry, with particular emphasis on the Act, in order to determine if the latest reforms are commensurate with existing policy, or whether they signal a reversion to the days of intense governmental intervention in the economy. The potential impacts of the Act, as identified by the author, will be compared and contrasted with the goals of competition and economic policy, in order to achieve this purpose.

[1] Doug Matheson, President, Electricity Supply Authority of New Zealand "Bradford Bill Reeks of Muldoonism", (Mediacom Press Release Distribution, Wellington, 12 June 1998). "Muldoonism" refers to the interventionist policies in place under former Prime Minister Sir Robert Muldoon. The term is synonymous with direct government intervention to control wages and prices, to regulate markets, trade and investment.

Section II begins by reviewing the functions of public utilities and describing the electricity industry prior to 1986. This will provide a necessary background to an understanding of the policy problems inherent in regulating utilities such as electricity. Many of the difficulties New Zealand still faces arise from the major expansion in the role of the State during the past hundred years.

Section III goes on to examine the historical source of public utility monopolisation. This general overview of the economic liberalisation policies of government since 1984 highlights the transition in the electricity industry from statutory monopoly to vertically integrated monopoly in energy companies; and in generation to a more transparent, but equally uncompetitive State-owned enterprise. The characteristics of New Zealand's approach to competition law and policy are described, because this law is used to underpin the regulation of the electricity industry. , Given that the emphasis of this paper is on consideration of the impact of the Act, there is only a brief examination of the Commerce Act 1986 and the cases decided under it, and of the Electricity (Information Disclosure) Regulations 1994.

Section IV provides an analysis of the impact of the state sector and competition law reforms on the electricity industry. Certain unresolved monopoly problems directly triggered the introduction of the Act.

A detailed outline of the Act is given in Section V. Little published commentary exists on the Act at present and for this reason, an examination of its core provisions and their possible legal implications, is essential. Certain criticisms have been levelled at the Act - not least for its complicated nature.

Finally, Section VI assesses the Act in terms of its compatibility with the rationale for, and effect of, prior electricity reform in New Zealand. The industry-specific structure developed by the Act, which is backed by general antitrust legislation, is not found to be heavy-handed in terms of competition law. However, it will ultimately involve greater State involvement in the electricity industry, contrary to the general economic

philosophy of the State maintaining its distance from commercial enterprise. Such involvement is ironic, unless, as submitted, the reforms herald a spate of privatisation of government-owned generating capacity. The further conclusion is drawn that the Act has imposed a new and drastic form of government interference on the electricity industry. The forced divestment of power companies' assets is extraordinarily intrusive intervention in the private property rights of businesses, communities and investors.

A The Components of the Electricity Industry

It is convenient at this stage to examine the five stages of production, delivery and sale of electricity to consumers in New Zealand.

1 Generation

New Zealand's electricity generation is sourced in hydro-electric, wind-powered, geothermal, natural gas and coal fired thermal power stations. Hydro electricity accounted for about 79 per cent of electricity generation in 1996,[2] despite the fact that New Zealand's hydro lakes have a total storage capacity of only about 12 per cent of the annual electricity demand (this equates to approximately 10 weeks storage).[3]

2 Wholesale Electricity Market

The trading of electricity in the wholesale market is a system of trading electricity in which electricity contracts can be traded independently of ECNZ. The industry has moved rapidly from a situation where the price was set by a monopoly supplier to one where prices are based on bids and offers from market participants.

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[2] Ministry for the Environment, Ian Smith (chief ed) *The State of New Zealand's Environment* (Ministry for the Environment, 1997), 3.21.

[3] Dave Frow "New Zealand Electricity - Past, Present and Future" ", *Conference of the Electric Power Supply Industry Keynote Address* (Christchurch, 19-23 September 1994), 35.

3 Transmission

Electricity is transmitted throughout New Zealand from power stations to regions of substantial electricity consumption by high capacity, high voltage (220,000 volts) interlinked transmission lines (the national grid) owned by Trans Power.

4 Distribution

Electricity is distributed locally by power company distribution networks that operate at lower voltages (110,000, 33,000 and 400 volts) and in smaller geographic areas than Trans Power's transmission line network. Distribution concerns the operation and management of the lines, cables, transformers, switches and other physical equipment which is needed to cause electricity to flow from Trans Power's substations to those places where consumers use electricity.

5 Retailing

Power companies and independent retailers sell electricity to consumers. They pay Trans Power for access to its transmission network to transmit electricity from power stations to its substations prior to distribution and sale.

II PUBLIC UTILITIES IN NEW ZEALAND

Public utilities are individuals and companies that provide the public (or a section of it) with gas, water, telecommunications, or electricity. Public utilities have two distinguishing characteristics:[4]

1) they provide a distribution, transmission or transport service through a network of cables, pipes or other facilities that tend to enjoy such large-scale economies as to become natural monopolies.[5]

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[4] Michael Taggart "Public Utilities and Public Law" in Philip A Joseph (ed) *Essays on the Constitution* (Brookers, Wellington, 1995), 214.

[5] See text at footnote 15.

2) the service they provide is often an "essential" input to other industries, so the efficiency of utilities has a widespread impact on the efficiency of other firms. (Essential facilities are those that cannot practically be duplicated, and to which access is required by those who wish to compete in up or downstream markets.)[6]

Historically, public utilities in New Zealand have been predominantly state-established, owned and run. State ownership was a means of ensuring the development and financing of socially important industries.[7] By the 1970s almost every utility service was provided by large State trading departments or divisions. These operated under statutory monopoly rights and were heavily regulated in terms of price-setting, investment planning, and other operating conditions.

A The Electricity Industry Prior to 1986

The Electricity Industry in New Zealand prior to the State sector reforms of the 1980s was a prime example of a State-owned and operated public utility, subject to extensive political control and involvement via government regulation. The Electricity Division of the Ministry of Energy ("NZED") was responsible for 96 per cent of electric generation, and for the national grid (transmission).[8] This monopoly in generation was entrenched by the Electricity Act 1968, which provided that the NZED was not required to hold a licence to generate electricity from hydro sources, but other generators using hydro as a resource required a licence from the government.[9]

The balance of the generation capacity and responsibility for distribution was held by Electricity Supply Authorities (ESAs). ESAs were set up as statutory ad hoc bodies under the Electric Power Boards Act 1925, or as Municipal Electricity Departments of

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[6] Terence Arnold *The Courts, the Commerce Act and the Pricing of Access to Essential Facilities: Law and Economics at Work?*, A paper delivered to the LEANZ Group, 5 December 1994, 2.
[7] The increasing role of the State in New Zealand's electricity industry prior to 1986 has been summarised in Appendix I.
[8] Geraldine Baumann, Bryan Gunderson and Quentin Hay "The Contractual Matrix in a Deregulated Electricity Industry", *Conference of the Electric Power Supply Industry* (Volume 2, Christchurch, 19-23 September 1994), 122.
[9] Electricity Act 1968, s 20.

Local Authorities under the Local Government Act 1974. In 1985 there were 44 local distribution and supply authorities, as compared to 93 in 1945, in a country of 3.2 million people.[10]

The ESAs were local body owned, statutory monopolies. They held monopoly franchises in their areas for the distribution and retailing of electricity, and were required to buy from the NZED except where they had specific government exemptions.[11] ESAs generally operated with non profit-making and social service objectives, rather than a commercial focus. For example, they were obliged by statute to supply domestic consumers.[12] ESA boards were frequently involved in the day to day management of the organisations. Commercial customers generally subsidised domestic customers.[13]

Commercial interaction between the NZED and the ESAs was limited. The NZED provided electricity to the supply companies under the Bulk Supply Tariff, which was set annually by the government - an arrangement that was politically rather than commercially motivated. This reflected the government's duty under the Electricity Act 1968 to supply all electricity needs.

III THE HISTORICAL SOURCE OF PUBLIC UTILITY MONOPOLISATION

A Inefficiency in the Public Sector

Widespread concern about inefficiency in the public sector resulting from statutory monopolies, such as the NZED, was one factor stimulating the extensive public sector reform of the 1980s. In general, the losses that such monopolies impose on society are

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[10] Tony Fenwick, Ministry of Commerce "A Competition Law Assessment of New Zealand's Electricity Reforms" *Competition Law and Policy Institute of New Zealand Ninth Annual Workshop*, 31 July - 1 August 1998, 2.

[11] Electricity Act 1968, s 26.

[12] Electrical Supply Regulations 1967, r 19(2); Electrical Supply Regulations 1984, r 17(2).

[13] Russell McGeorge "An Overview of the Reform of the Electricity Industry", *Conference of the Electric Power Supply Industry* (Volume 1, Christchurch, 19-23 September 1994), 173.

more likely to be associated with excessive prices and excessive costs than with a high level of reported profits. It is essential to understand the problems created by monopolies in order to understand the rationale behind the State sector reforms of the 1980s.

The inefficiency of public sector enterprises in New Zealand - which covered, but were not limited to, utilities - imposed a heavy burden on the economy. In 1984 State-owned trading enterprises accounted for about 12 per cent of GDP, and for about 20 per cent of investment in the economy, but despite this they had very low rates of return. Since they often produced essential inputs used by firms in the private sector, their efficiency, price-setting and investment behaviour had a major impact on the competitiveness of the economy as a whole.[14]

B Natural Monopolies

The term "natural monopoly" has traditionally been used to describe those industries in which only one firm operates (or has significant market dominance) due to characteristics endogenous to the industry, rather than due to some artificial property right such as a patent or licence. Other market entrants cannot economically duplicate their networks or produce the range of outputs at a lower cost than the monopolist because of the monopolist's large, lumpy immobile investments in sunk assets, and the scale economies derived from the network operations. The transmission and distribution sectors of the electricity industry are natural monopolies, although generation and retail are not usually considered to be so.

Economic theory suggests that natural monopolies with significant market dominance may create public policy concerns because they may have higher production costs, they

[14] A Bollard and M Pickford "Utility Regulation in New Zealand" in M E Beesley (ed) *Regulating Utilities: Broadening the Debate* (Institute of Economic Affairs and London Business School, London, 1997), 94 ("Utility Regulation in New Zealand").

may charge higher prices, and they may innovate more slowly than firms subject to competitive pressures.[15]

C State Sector Reform

As part of wider economic liberalisation policies, the public utility industries were progressively reformed in the years following 1985. The basic thrust of the State sector reforms was to free the market mechanism from distorting government controls and subsidies. The emphasis was on allowing the forces of enterprise, self-interest, and competition to generate efficiency and economic growth.[16] These reforms included:

a) removal of statutory monopoly rights so as to expose utilities to competition and allow commercial criteria to provide a fair assessment of managerial performance;

b) restructuring to separate responsibility for non-commercial or policy functions from trading functions;

c) corporatisation and privatisation, to give commercial objectives and allow managers the responsibility for decisions on the use of inputs, on pricing, and on the marketing of their outputs;[17]

d) restructuring to isolate natural monopoly elements from contestable parts of industries and to reduce barriers to competition in the contestable parts of industries;

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[15] Ministry of Commerce and The Treasury *Regulation of Access to Vertically Integrated Natural Monopolies* (Ministry of Commerce, Wellington, 1995), 4 ("*Regulation of Access to Vertically Integrated Natural Monopolies*").

[16] "Utility Regulation in New Zealand", above n 13, 79

[17] The analytical foundations of the corporatisation and deregulation policies lay in principal-agent theory. Principal-agent theory holds that life is a series of contracts between a principal and an agent and that these contracts require clear objectives, good information, monitoring and incentives to function effectively. Privatisation was driven by the ideology of the New Right - managerialism and the New Public Management ("NPM"). Managerialism involves the emulation in the public sector of the principles and practices of the private sector - "letting the managers manage". NPM also prefers private ownership and advocates the disaggregation of large bureaucratic structures into quasi-autonomous agencies, in particular the separation of commercial from non-commercial functions and policy advice from delivery and regulatory functions.

and

e) abolition of social service obligations.

The first major State sector reform in the pursuit of efficiency and accountability was the State-Owned Enterprises Act 1986 ("SOE Act"). The overriding statutory objective of each State-owned enterprise ("SOE") was to run a successful business as profitably and efficiently as comparable private sector businesses.[18] Under the SOE Act the Crown retained ownership of trading activities, but the enterprise was run by a government-appointed Board of Directors that was accountable to the shareholding ministers for the company's performance.[19]

D Deregulation of the Electricity Industry

1 Generation and Transmission Sector Reform

These economic reforms were translated to the electricity industry over a number of years. Electricity reform began in the generation and transmission sector with the corporatisation of the NZED into the Electricity Corporation of New Zealand ("ECNZ") on 1 April 1987 under the SOE Act 1986. This was the beginning of a fundamental shift in policy towards treating electricity like a commodity and exposing the industry as much as possible to the forces of market competition.[20] The government relinquished direct control over electricity pricing to ECNZ's Board of Directors. However, electricity supply provided as part of government social policy continued to be subsidised by the government, and did not form part of ECNZ's commercial objectives.[21] This allowed transparency in the costing of supply and prevented ECNZ's responsible ministers from using the SOE for political motives.

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[18] State-Owned Enterprises Act 1986, s 4(1)(a).
[19] The Minister of Finance and the Minister of State-Owned Enterprises.
[20] Barry Barton "More Restructuring: the Government's New Proposals for Electricity Reform" (1998) 2 *BRMB*, 134.
[21] State-Owned Enterprises Act 1986, s 7.

In 1988 Trans Power was set up as a separate corporate entity, a subsidiary of ECNZ, as part of the thrust towards separation of monopoly and potentially competitive elements. The policy was solidified in April 1994, when Trans Power was separated from ECNZ and established as an independent SOE, allowing competition to be introduced to the generation sector.

In June 1995 the government announced that ECNZ would be split into two competing SOEs (ECNZ and Contact Energy), to enable greater competition in generation to develop. Contact received 28 per cent of New Zealand's total generating capacity, as well as ECNZ's rights to Maui Gas. Pursuant to a 1995 Memorandum of Understanding, ECNZ was restricted from using its larger size to dominate the market. Special constraints on ECNZ - prohibiting it from acquiring any ESA (or any significant share in an ESA) - were to apply until ECNZ's market share of total generating capacity fell to 45 per cent. These constraints included a cap on building new capacity to ensure that at least 50 per cent of additional generating capacity in New Zealand was built by parties independent of ECNZ; the ring-fencing of new capacity; and a high level of firm capacity to be offered on long term contracts. [22]

In October 1996 the Wholesale Electricity Market ("NZEM") became fully operational, allowing a number of generators to offer varying amounts of electricity to a range of competing buyers. The NZEM comprises two different markets. The first is a physical spot market (pool) in which competing generators offer electricity, and buyers submit bids into the pool for each half hour period, resulting in clearing prices and quantities for dispatch by the scheduler, Trans Power. The second is a contracts market in which buyers and sellers can trade contracts for supply one day ahead which hedge against spot prices in the pool.[23]

Financial hedges allow purchasers of electricity the ability to avoid price uncertainty. For example, ECNZ energy supply contracts provide for hedges against the week ahead

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[22] Memorandum of Understanding entered into on 8 June 1995 by the Government of New Zealand and Electricity Corporation of New Zealand.

[23] Ministry of Commerce *Chronology of New Zealand Electricity Reform* (Ministry of Commerce, Wellington, 1998), 10.

price. If the week ahead price is higher than the hedge price, ECNZ pays the customer the difference between the two prices to compensate the customer for the higher cost of electricity. If the week ahead price is lower than the hedge price, the customer pays ECNZ the difference between the two prices to compensate ECNZ for the lower price of electricity.[24] Hedges are classified as futures contracts under the Securities Amendment Act 1988, since each party has a right to receive payment or credit of a sum of money, depending on whether the price is greater or lesser than the price agreed on at the time of the hedge.[25]

2 *Retail and Supply Sector Reform*

The Energy Companies Act 1992 and the Electricity Act 1992 formed the initial legislative basis for the restructuring of the electricity supply sector.

(a) The Energy Companies Act 1992

The Energy Companies Act 1992 required corporatisation of the Electric Power Boards and Municipal Electricity Departments of Local Authorities,[26] whereby the assets of the utility operation were to be transferred to the company. Forty-four ESAs were corporatised under this Act.[27] The government's initial intention was that all corporatised entities should be publicly listed. However, a range of ownership structures was adopted, including charitable trusts, consumer trusts, local government ownership and full public listing on the New Zealand Stock Exchange. Section 36(1) of

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[24] See Commerce Commission Decision No. 277, 30/1/96.

[25] P Castle and S Watt "Regulatory and Contractual Requirements for Energy Price Risk Management Programmes", *Electricity Price Risk* (Wellington, Institute for International Research, 4 March 1997).

[26] Energy Companies Act 1992, Part IV.

[27] In the North Island these ESAs included; Top Energy, Northpower, Waitemata Electricity, Mercury Energy, Counties Power, Waikato Electricity, Valley Power, Tauranga Electric Power Board, Tauranga Electricity, Bay of Plenty Electricity, Eastland Energy, Waipa Power, Waitomo Energy Services, Rotorua Electricity, King Country Energy, Taupo Electricity, Wairoa Power, Hawke's Bay Power, CHB Power, Powerco, Taranaki Energy, Egmont Electricity, CentralPower, ScanPower, Electro Power, Horowhenua Energy, Wairarapa Electricity, PowerDirect, Capital Power.
In the South Island these ESAs included: Citipower, Marlborough Power, Tasman Energy, Buller Electricity, Westpower, MainPower, Southpower, Electricity Ashburton, Alpine Energy, Waitaki Power, Central Electric, Otago Power, Dunedin Electricity, The Power Company and Electricity Invercargill. See McGeorge, above n 12, 174.

the Energy Companies Act imposed a commercial success requirement on all the new companies.

(b) The Electricity Act 1992

The Electricity Act 1992 provided for the deregulation of the retail sector, including the removal of statutory monopolies and the obligation to supply. It also removed the exclusive electricity supply franchise areas,[28] abolished the right of electricity suppliers to enter private property to construct and maintain electrical works (other than existing works),[29] and provided for safety matters.

Most importantly, the Electricity Act 1992 provided for information disclosure regimes focused on natural monopolies.[30] It required the compulsory public disclosure of certain annual financial and performance information pertaining to the power companies, and the accounting separation (ring-fencing) of the distribution business and the retailing business within each company. Finally, section 62 of the Electricity Act 1992 required the compulsory maintenance of line services until 2013.

3 Creation of Vertically Integrated Monopolies

Corporatisation and privatisation of distribution companies occurred without divestment from the natural monopoly lines businesses, thereby creating "vertically integrated natural monopolies". Vertical integration occurs where a monopoly firm providing a monopoly service integrates into an upstream market, downstream market, a distinct horizontal market, or any combination of these.[31]

The only step the government took to prevent vertical integration in the electricity sector was to prohibit ECNZ from owning lines businesses. Lines businesses, however, were not prevented from owning generation assets. In the July 1995 Memorandum of

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[28] Electricity Act 1992, s 71.
[29] Electricity Act 1992, s 23.
[30] Electricity Act 1992, s 170.
[31] *Regulation of Access to Vertically Integrated Natural Monopolies*, above n 15, 3-4.

Understanding with ECNZ,[32] the government constrained ECNZ to offer the Cobb, Coleridge, Highbank, Matahina, Taui, Piripaua, and Kaitawa hydro-stations to regional energy companies. This was notwithstanding that, should energy companies purchase those stations, the vertically integrated character of the natural monopoly lines businesses would be further exaggerated.

E Reform of Competition Law and Policy

The revision of competition law and policy ran parallel to economic reform in New Zealand. A light-handed framework for the regulation of corporatised and privatised utilities with market power was adopted. This regime was heavily dependent on the Commerce Act 1986 ("the Commerce Act"), which defined the rules by which business were to operate in the newly deregulated economy. The Commerce Act aimed to deter the possible spread of restrictive practices and mergers by firms wishing to reduce what, for many, would be unfamiliar competition. Competition and competitive practices are:

> "... by far the most effective means of protection against monopoly. Vigilance against anti-competitive practices is also important. Profit regulation is merely a "stop-gap" until sufficient competition develops".[33]

Effective competition involves real and vigorous rivalry between two or more parties to promote economic efficiency. Effective competition is achieved by aligning prices with costs, by increasing pressures for cost reduction, by selecting more efficient firms from less efficient firms, by promoting innovation, and by diminishing the inevitable imperfections of regulation. [34] Such competition in utilities might be thwarted by barriers to entry or anti-competitive behaviour by a dominant incumbent.[35]

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[32] See above n 22.
[33] S Littlechild *Regulation of British Telecommunications Profitability* (HMSO, London, 1983), 91.
[34] John Vickers "Competition And Regulation: The UK Experience" in M E Beesley (ed) *Regulating Utilities: A Time For Change?* (Institute of Economic Affairs and London Business School, London, 1996).
[35] See text at footnotes 54-63.

F Light-handed Regulation

1 Policy

Light-handed regulation reflects the market paradigm - its focus is on market participants determining their own solutions to issues of economic development and resource allocation with minimum interference from "regulators". This avoids both an industry-specific regulator and direct government control of prices. The framework is consistent with the view that it is competition, not regulation, that will, in time, succeed in driving down costs in a sustainable manner and overcoming the non-statutory entry barriers enjoyed by any dominant incumbent.[36]

The Commerce Act is designed to promote market conditions where competition and economic efficiency can thrive.[37] In *Tru Tone Ltd v Festival Records Retail Marketing Ltd* the Court of Appeal stated that the Commerce Act:[38]

> "... is based on the premise that societies' resources are best allocated in a competitive market where the rivalry between firms ensures maximum efficiency in the use of resources."

This objective does not provide any impetus for the development of competition; it simply inhibits firms imposing their own restrictions, arrangements and practices which have an anti-competitive purpose or effect. However, this objective can be overridden in certain circumstances where efficiency advantages are considered to outweigh detriment from the loss of competition. The overall thrust of the policy is to encourage competition where markets are potentially contestable, and to focus regulation on the non-contestable markets controlled by incumbent utilities.[39]

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[36] New Zealand Business Roundtable *Regulation of Network Industries: The Case of Telecommunications* <http://www.nzbr-org.nz/pdf-format/PDF-006-network/nzbr_network_industries.pdf, 1998>, 42.
[37] Commerce Act 1986, Title: "An Act to promote competition in markets within New Zealand and to repeal the Commerce Act 1975".
[38] [1988] 2 NZLR 352, 358 (CA).
[39] "Utility Regulation in New Zealand", above n 14, 98.

The Commerce Act is generic legislation governing competition in all industries, and with a focus on regulating the behaviour of firms. It is administered by a politically independent body - the Commerce Commission - whose decisions can be appealed through the Courts.

2 *Components of Light-handed Regulation*

Light-handed regulation consists of three components:[40]

a) Information disclosure, to create transparency in the performance of businesses with market power, to encourage self-regulation and to provide recourse to the provisions of the Commerce Act;

b) Use of Part II of the Commerce Act (restrictive trade practices provisions) to deal with anti-competitive behaviour, including the possibility of court action by private parties or the Commerce Commission; and

c) The threat of further regulation, such as the introduction of price control, if market dominance is abused.

(a) Information Disclosure

Information disclosure is a technique designed to discourage monopoly pricing, uneconomic electricity generation, and excessive cross-subsidies between consumer classes. It is intended to foster competition in an industry by promoting open access to natural monopolies, exposing predatory pricing and revealing any cross-subsidies between natural monopoly and competitive activities.[41]

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[40] Ministry of Commerce, Energy and Resources Division, Energy Policy Group *Light-Handed Regulation of New Zealand's Electricity and Gas Industries* (Ministry of Commerce, Wellington, October 1995), 1 (*"Light-Handed Regulation"*), 1.

[41] *Light-Handed Regulation,* above n 40, 4.

This approach was implemented in the electricity industry by the Electricity (Information Disclosure) Regulations 1994, which required participants in the electricity industry to publicly disclose information about their activities. These regulations apply to ECNZ as well as its subsidiaries, electricity generators, retailers and distributors, subject to exemptions granted by the Secretary of Commerce. They call for public disclosure of:

a) separate audited financial statements for natural monopoly and potentially competitive businesses within five months after the end of each financial year;

b) prices and other main terms and conditions of contracts;

c) financial performance measures, based on standard asset values (Optimised Deprival Value)[42] and with removal of any elements of double counting of asset related expenditure;

d) efficiency and reliability performance measures;

e) costs and revenues by tariff category (and methodologies); and

f) line charges (and methodologies).

Information is publicly disclosed by publication in the *Gazette*, by making information available for inspection at the principal trading offices, or by providing information on request. In this manner the Electricity (Information Disclosure) Regulations 1994 aim to encourage self-regulation through the market, thereby underpinning the effectiveness of the Commerce Act. The availability of the information is also intended to increase transparency, enabling participants in the electricity industry and others to detect and challenge anti-competitive conduct.

[42] Optimised Deprival Value (ODV) is the lesser of Optimised Depreciated Replacement Cost (ODRC) and Economic Value (net present value of future cash flows).

(b) Part II of the Commerce Act 1986

Under section 27 of the Commerce Act, contracts, arrangements or understandings that have "the purpose or effect of substantially lessening competition" are prohibited. Section 30 deems a contract, arrangement or understanding that has the "purpose or effect of fixing, controlling or maintaining prices" for goods to be one that substantially lessens competition. The significance of section 30 is that it removes any need to establish that competition has been substantially lessened, which is usually the main ground on which section 27 allegations are defended.

Section 36 is probably the most important provision for regulation of utilities. It prohibits firms from using their dominant positions for the purpose of restricting, preventing, deterring or eliminating competition. The Privy Council decision in *Telecom Corporation Limited v Clear Communications Limited*[43] has significantly reduced the effectiveness of section 36 by restricting the definition of "use" of dominance. The test for "use" is now whether a dominant firm, otherwise in the same circumstances as the dominant firm, but not in a dominant position, would act in the same way.

However, the charging of a "monopoly price" in itself is not prohibited, although the inference is that monopoly profits should be competed away where entry is possible.[44] Contravention of the Part II provisions attracts serious sanctions. An individual contravener may be liable for penalties of up to $500,000, and a corporate contravener may be liable for up to $5,000,000.[45] Court injunctions may be granted to restrain future contraventions,[46] and a contravener may be liable to compensate any person who suffers loss.[47]

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[43] [1995] 1 NZLR 385; (1994) 5 NZBLC 103,552; (1994) 6 TCLR 138; (1994) 32 IPR 573.
[44] *Clear Communications Limited v Telecom Corporation Limited* (1993) 4 NZBLC 103,340, 103,344 (CA).
[45] Commerce Act 1986, ss 80,83.
[46] Commerce Act 1986, Part VI.
[47] Commerce Act 1986, s 89.

(c) Part IV of the Commerce Act - Price Control

Part IV of the Commerce Act is a "sword" that hangs over firms operating in markets with limited competition.[48] It provides the threat of imminent regulation to ensure players in the industry act in good faith. If the light-handed approach is perceived as being ineffective, the threat is that the government will adopt a more "heavy handed" approach and fix the prices for particular components in the industry.

The Commerce Act makes provision in Part IV for the imposition of price control in circumstances of restricted competition. The Minister of Commerce may recommend to the Governor-General that the prices for goods or services be controlled where he or she is satisfied that the relevant goods will be supplied in a market in which competition is limited or is likely to be lessened, and where it is necessary for the price of those goods or services to be controlled in the interests of users or consumers. This should act as a deterrent to abuse of market dominance.

IV THE IMPACT OF STATE SECTOR AND COMPETITION LAW REFORMS

A Positive Results of the Reforms

A certain amount of competition was introduced to the electricity generation and retail sectors following the economic reforms of the 1980s, particularly after the advent of the wholesale electricity market. The success of the electricity industry reforms of the early 1990s is apparent in a comparison of delivered power price increases. Power prices to New Zealand's domestic users have not risen as sharply as those in our OECD counterpart countries since 1992. According to the Energy Data File for 1997, compiled by the Ministry of Commerce, New Zealand's electricity prices were the fourth lowest in the world, behind Mexico and Canada (with huge gas resources for cheap generation) and Norway (with a massive hydro storage resource).[49]

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[48] Dr Alan Bollard, Chairman, Commerce Commission "Regulation of Competition in the Electricity Industry" in Institute for International Research *Conference on Exploiting Opportunities and Future Developments in Electricity Rationalisation* (Institute for International Research, Auckland, 29 March 1995), 11.

[49] Ministry of Commerce *Energy Data File* (Ministry of Commerce, Wellington, July 1997, January 1998).

B Unresolved Problems

1 Problems in Generation

A range of problems continue to exist in today's electricity generation, distribution and supply businesses. In generation these include continuing ECNZ dominance in the spot and contracts markets, which has caused spot and contract prices to be significantly higher than they would be in a fully competitive market.[50] Although ECNZ's wholesale electricity price has fallen 14.7 per cent in real terms since 1989, aggregate retail prices rose by 5.6 per cent in the 1995/96 year. [51] Obviously, reduced wholesale prices have not been reflected in domestic electricity prices. A further problem is that of over capacity resulting from premature committal of generation investment:[52]

> "Since 1995 some 1,350 MW of new, base load, generating capacity has been committed to construction or commissioned. This represents a substantial increment in new generating capacity and the bulk of it will be designated to operate at full load on a continuous basis ... All of this plant will be in operation by the year 2000 and will add some 10,000 GWh to annual base load energy production ... This excess of supply over demand is likely to place substantial competitive pressure over the next few years on the higher cost, older technology power stations in the ECNZ and Contact portfolio."

2 Problems in Distribution and Supply

While the earlier electricity distribution and supply reforms have improved efficiency in the industry they have not benefited smaller consumers. At present the level of retailing competition is low - only three per cent of all electricity generated is traded across

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[50] Ministry of Commerce *"A Better Deal for Electricity Consumers": An Outline of the New Zealand Government's Electricity Reform Package* (Ministry of Commerce, http://www.moc.govt.nz/ran/empg/blueprint/blueprint00.html, 7 April 1998), 3 (*"A Better Deal for Electricity Consumers"*).

[51] Electricity Corporation of New Zealand Limited *Annual Report. Year Ended 30 June 1997* (Wellington, 1997), 5.

[52] Keith Turner and Kieran Murray *Report for OCEP - Competition in Electricity Generation - Options for a Further Split of ECNZ*, (Wellington, August 1997) 18-20.

regional monopoly boundaries.[53] In particular, there are two recognised concerns with the status quo that reveal the inadequacy of New Zealand's light-handed regulatory regime in promoting competition, and in ensuring that gains from further generation reform will be passed on to consumers, namely:

a) the vertical integration of lines businesses with electricity businesses. This permits cross-subsidisation and bundling of prices and services by electricity supply companies such as to discourage entry by independent retailers. This gives an unreasonable advantage to incumbent electricity supply companies. It also means that electricity supply companies are, in more general terms, open to high perverse economic incentives to use access issues to discourage entry by independent retailers; and

b) the ability of the owners of natural monopoly lines businesses to extract monopoly profits from both end-consumers, as well as those independent energy retailers ("independent retailers") who use their distribution lines to retail electricity.

3 Specific Unresolved Problems

(a) Access issues

A key issue since deregulation has been the ability of power companies and independent retailers to supply electricity to new customers via each others' distribution networks. Access issues arise when a firm, which desires to enter and compete in the electricity market, must have access to the facilities owned by the incumbent competitor in order to compete in that market. The incumbent firm may be unwilling to avail its facilities to potential competitors and may either refuse to make lines available, or make them available on restrictive terms and conditions in "use of systems" agreements.[54] Therefore, small consumers are confined to purchasing delivered electricity from their incumbent retailer.

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[53] Hon Winston Peters, Treasurer; Rt Hon Bill Birch, Minister of Finance; Hon Max Bradford, Minister of Energy "A Better Deal For Consumers. Electricity Reforms" (media release, 7 April 1998), 3.
[54] Cabinet Committee on Enterprise, Industry and Environment *Regulation of Access to Natural Monopolies* (CIE (96) 86, Wellington, 13 June 1996), 2.

The current system of metering, reconciliation and other transaction costs precludes small consumers from being supplied by competing retailers "wheeling" electricity over distribution networks.[55] This is because time-of-use metering renders small commercial and domestic energy use uneconomic. To date, regulatory policy has sought to address this problem by controlling the extent to which a lines business can discriminate in favour of its own associated retail activity. This generally involves an entrant's threat of litigation under the Commerce Act and reliance on information disclosure to monitor the existing regime.

The Commerce Act has not proved effective in handling access disputes. Section 36 of the Commerce Act was considered in *Telecom Corporation Limited v Clear Communications Limited,*[56] in which the Privy Council held that Telecom's insistence upon a price for access given by the "Baumol-Willig" rule was lawful under section 36. Essentially, the Baumol-Willig rule states that a firm seeking access should pay the incumbent a sum sufficient to compensate it for the opportunity cost of customers lost to the entrant, including its forgone profits, if any.[57] A Baumol-Willig access price may, therefore, include the monopoly profits that the incumbent loses by selling access in place of retail line services.

Although the Baumol-Willig rule is legal in New Zealand following *Telecom v Clear*, it is not current government policy. Ministerial disavowal of the rule creates considerable uncertainty when negotiating access to lines networks and provides additional bargaining power to the incumbent, essentially allowing it to charge Baumol-Willig rates.[58]

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[55] In the retail wheeling model, players in the distribution market may contract directly with the end-customer and use the local line business to "wheel" power directly to the end-customer. With effective retail wheeling, the retail distribution market is opened up to a wide variety of participants, including energy companies, brokers and marketeers, municipalities and other Government entities, retailers, generators, non-profit groups and consumer groups. See *Mercury Energy Limited v Power New Zealand Limited* (Commerce Commission Decision No. 317, 26/2/98), para 101.

[56] Above n 43.

[57] Cabinet Committee on Enterprise, Industry and Environment, above n 54, 8.

[58] Quentin Hay and Martin Taylor *Enhancing Competition in the New Zealand Electricity Market, Particularly at the End-User (Retail) Level. Discussion Paper Prepared for the Electricity Corporation of New Zealand Limited* (Bell Gully Buddle Weir, Wellington, 13 November 1997), 16.

Reliance on actions under the Commerce Act is also problematic because of the length and expense of litigation (itself potentially a barrier to entry that can be exploited by incumbent monopolists); and the inadequacy of penalties ordered under the Commerce Act to deter anti-competitive conduct.

The most recent competition action concerning access by competing electricity retailers to existing networks was brought by the Commerce Commission against Southpower. The Commerce Commission alleged that Southpower was using a dominant position in the market for purposes in breach of section 36 in terms of:[59]

(i) requiring persons whose premises were connected to their distribution network to enter a line services contract, whether or not Southpower actually supplied electricity to that person, thereby using their dominant position anti-competitively;

(ii) overstating charges to competing electricity retailers for use of distribution networks by overstating the true cost of the network distribution business and understating the true economic cost of its electricity retailing business; allocating over 90 per cent of its trading costs to its network distribution business; and allocating all its metering and billing services costs to the network distribution business; and

(iii) requiring competing electricity retailers to enter a conveyance agreement.

The case was settled out of Court in April 1998 when Southpower agreed not to contest the Commission's allegation that aspects of their terms of access for competing energy traders breached the Commerce Act. Southpower also agreed to some relatively minor - in terms of their competitive impacts - modifications to other business practices.[60]

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[59] *Commerce Commission v Southpower Limited* (1997) 8 TCLR 6.

[60] Deed of Settlement Between Commerce Commission and Southpower, 2 April 1998. These modifications included "ring fencing" and reducing the scope of the natural monopoly element of Southpower's business; placing contestable activities in separate corporate entities to facilitate the

(b) Cross-subsidisation and bundling

Vertically integrated power companies are able to cross-subsidise competitive activities such as retailing and generation from their captive lines customers. Cross-subsidisation involves direct and indirect transfer payments between lines and energy businesses, including the provision of discounted goods or services; and cross-allocation of costs, revenues, assets and liabilities between the businesses (particularly for potentially contestable operations, such as billing and metering). Costs may be associated with a wide spectrum of activities, from research and development costs through to costs associated with defending hostile takeovers.

Further illustrations of cross-subsidisation involve the operation of a lines business in a manner that favours the energy business - but that may not be in the best interests of the lines business itself - encompassing such matters as maintenance of distribution lines and timing of outages; and risk allocation between lines and energy businesses in such areas as contracting and financing activities.

Greater transparency of cross-subsidisation practices has not been achieved through the Electricity (Information Disclosure) Regulations 1994, as intended. Information disclosure as a means of light-handed regulation has instead encouraged innovative practices in vertically integrated power companies, designed to thwart the intent of the Electricity (Information Disclosure) Regulations 1994. For example, cross-subsidisation has been facilitated by electricity distributors' ability to inflate Optimised Deprival Value ("ODV") of the electricity lines business (thereby increasing the amount payable by a competitor wishing to use their lines),[61] and by unclear regulatory guidelines for the allocation of costs between energy and lines businesses.

The public and officials also face difficulty in determining, from the information disclosed under the Regulations, whether cross-subsidisation is actually occurring. For

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development of effective competition in respect of those activities; and to facilitate adherence to the competitive parity principle in the setting of terms of access to the network for independent retailers.

[61] See text at footnote 42.

example, in *Power New Zealand Limited v Mercury Energy Limited and Commerce Commission*[62] the High Court commented:

> "These Regulations are designed to make line charging more transparent. However, one would have to be a very well-informed consumer to be in a position to make much sense out of this highly complex information required to be furnished."

The case involved an appeal by Power New Zealand against the Commerce Commission's decision to allow Mercury Energy, New Zealand's largest power company, to acquire 100 per cent of the shares in Power New Zealand, the country's second largest power company. The case was finally decided in the Privy Council, where it was noted that information disclosure does not simplify the process of making meaningful comparisons between power companies' activities (the desired intent of the Electricity (Information Disclosure) Regulations 1994).[63] The Privy Council said:

> "The regulations allow a degree of differing interpretation by each power company in defining what makes up each business and how costs and assets should be allocated between the line and energy (or other) businesses of the power company .... However, the ability to make inter-company comparisons is also handicapped by the different size, customer mix, and geography of the power companies."

The Privy Council thought it unnecessary to consider the extent to which the information disclosure regime provides a constraint upon power companies. The decisive point was that the elimination of Power New Zealand would have very little effect upon the availability of comparative material, both within New Zealand and internationally. Post-acquisition, each company would continue to report separately for information disclosure purposes, but disclosure would be less meaningful as a result of the greater level of common ownership. The Privy Council also considered that TransAlta and Southpower would provide useful comparisons with the post-acquisition entity.

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[62] [1996] 1 NZLR 686, 694.
[63] *Mercury Energy Limited v Power New Zealand Limited* (Commerce Commission Decision No. 317, 26/2/98), para 129.

(c) Monopoly profits

The existence of monopoly allows "excess" profits to be earned by the organisation possessing market power because monopolies reduce output and raise prices to maximise profits. In the electricity industry monopoly profits are enhanced by the inelastic demand curves created by universal appliance ownership and the requirement for electricity to power these appliances.

V THE ELECTRICITY INDUSTRY REFORM ACT 1998

A Overview of the Electricity Industry Reform Act 1998

The Act was passed on 3 July 1998 within a very tight time frame. The select committee process took place over a three day period. Its terms of reference allowed only technical and implementation issues to be reviewed, as opposed to the substantive policy behind the Act. A total of 224 submissions were received by the Commerce Select Committee, 101 of which were presented orally. The majority of the submissions opposed the legislation. The Act is extremely complicated and as yet there is little published commentary on its provisions. For this reason an examination of its content may aid understanding and is essential to further the thesis of this paper. The obvious policy incentives for the Act will be highlighted in a discussion of the purpose provisions, and of the means by which the Act fulfils these purposes. Certain blatant legal questions and problems will be considered in discussion of the core provisions However, at the time of writing the significance of these potential problems is uncertain and conjecture would be inappropriate.

1 Policy Overview

The problems identified in the current generation, distribution and supply structures provided the impetus for further reform of the electricity sector. According to the 7 April 1998 Reform Outline,[64] the government's overall energy policy is to ensure that:

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[64] Ministry of Commerce *"A Better Deal for Electricity Consumers": An Outline of the New Zealand Government's Electricity Reform Package* (Ministry of Commerce, http://www.moc.govt.nz/ran/empg/blueprint/blueprint01.html, 7 April 1998),2.

a) electricity is available when required by consumers;

b) electricity is produced at the lowest possible cost to the economy as a whole; and

c) harm to the environment is minimised.

The Minister for Enterprise and Commerce, Max Bradford claimed:

> "The reforms are designed to kick along the pace of competition and choice for consumers" [65]

> "The contents of this Bill reflect the Government's commitment to delivering world best practice electricity services to all New Zealanders. The electricity reforms are about getting a better deal for consumers, especially household consumers. The electricity reforms will deliver choice and lower electricity prices. In this way the Government is also seeking to improve New Zealand's international competitiveness by significantly lowering energy costs for business."[66]

The risks of barriers to distribution lines and of the cross-subsidisation of energy and lines businesses were to be addressed through separating ownership of the monopoly lines businesses and the potentially competitive supply businesses. It was envisaged that this structural solution would allow:[67]

> " ..... vigorous [retail] competition wherever possible, combined with an effective regulatory regime where competition is not possible, most notably in the transmission and distribution (lines) business."

Other stated objectives of government included facilitating the amalgamation of energy businesses and of lines businesses and delivering a low cost option to enable small consumers to switch electricity suppliers. If the industry is unable to deliver a low cost switching option within twelve months, the government plans to regulate for a mandatory default switching system and increase the threat of price control of line

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[65] Max Bradford, Media Release, 7 April 1998.
[66] (19 May 1998) 568 NZPD, 9151.
[67] *"A Better Deal for Electricity Consumers*, above n 50, 1.

charges through the Commerce Commission. However, the system of agreements entered into between suppliers for lower cost rules to assess half hourly electricity consumption, and the proposal of data reconciliation as a low cost switching option is beyond the scope of discussion in this paper.

2 *Ownership Separation versus Corporate Separation*

To a certain extent the recent reforms were foreshadowed by earlier restructuring attempts. In 1995 the government expressed its concern at the ability of owners of natural monopoly distribution lines to stifle retail competition. In particular, the government issued a statement that was emphasised by the proponents of the Act:[68]

> "If there is a clear and consistent pattern of abuse of natural monopoly line businesses, the Government would seriously consider requiring the ownership of line businesses to be separated from ownership of competitive activities, such as generation and energy retailing".

The government's decision to split lines and energy businesses was influenced by overseas developments. A recent OECD report has given credence to ownership separation as a means to preventing vertically-integrated natural monopolies from using their market power in distribution to exclude competition. The report noted that:[69]

> "...restructuring ownership and changes in regulatory institutions are likely to be prerequisites for the introduction of competition especially if the industry is likely to be highly concentrated horizontally and vertically integrated."

Reforms in the UK gas markets that resulted in the ownership separation of British Gas, thereby promoting competition and regulatory effectiveness were also persuasive. British Gas originally had the integrated functions of sale of gas and ownership of the monopoly gas transportation system. The British Monopolies and Mergers Commission

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[68] Government Policy Statement *Wholesale Electricity Reform. Regulation of Electricity Lines Businesses* (Wellington, 8 June 1995).

[69] OECD Report on Regulatory Reform Volume I, *Sectoral Studies*, 165. The weaknesses of accounting separation can be found on page 173.

(MMC) perceived this integrated role to be generating a conflict of interest, extinguishing the conditions necessary for self-sustaining competition. The dual role inhibited choice, restricted innovation, and led to higher levels of gas prices than would otherwise have been the case. British Gas proposed a corporate split - the establishment of separate trading and transportation units under its common ownership. The MMC considered this proposal inadequate to remedy the restrictions on competition and recommended the divestment of British Gas's trading activities. The MMC said:

> "Such a measure [divestment] would not, in our view, put at risk security of supply or safety. It would involve considerably less costs and organisational change than many other remedies put to us. Although some increase in costs in the short term may result, the development of self-sustaining competition would bring significant benefits to consumers. We regard separation of the businesses as essential to ensure that transportation and storage can be made available to all shippers, including the trading activity currently carried out by British Gas, without undue discrimination. Such a measure would remove the existing conflicts of interest, provide the incentives necessary to ensure the neutrality of transportation and storage, and bring about the transparency necessary for the regulation of the system."

3 *Expression of Policy Considerations*

The most obvious policy considerations were drafted into the Act in the broad purpose provisions. Section 2 provides that the purpose of the Act is to reform the electricity industry to better ensure that -

> (1)(a) Costs and prices in the electricity industry are subject to sustained downward pressure; and
>
> (b) The benefits of efficient electricity pricing flow through to all classes of consumers - by -
>
> (c) Effectively separating electricity distribution from generation and retail; and
>
> (d) Promoting effective competition in electricity generation and retail.
>
> (2) The particular purpose of Parts 1 to 5 (separation of lines and supply) is -
>
> (a) To prohibit certain involvements in electricity lines businesses and electricity supply businesses which may create incentives and opportunities -
>
> (i) To inhibit competition in the electricity industry; or

(ii) To cross-subsidise generation activities from electricity lines businesses; and

(b) To restrict relationships between electricity lines businesses and electricity supply businesses which may otherwise not be at arms length.

(3)The particular purpose of Part 6 (price restraint) is to enable, in the event of a change in charges for line function services, the protection of domestic and rural consumers against a rate of change and level of change that is inappropriate.

(4) The particular purpose of Part 7 (amendments to Electricity Act 1992) is to facilitate competition among electricity retailers and choice for consumers.

(5) The particular purpose of Part 8 (split of ECNZ) is to promote effective competition in electricity generation by enabling the shareholding Ministers of Electricity Corporation of New Zealand Limited to require assets and liabilities of that company or of any wholly-owned subsidiary of that company to be transferred to the Crown or to any other State enterprise or subsidiaries of State enterprises.

3 Retrospective Provisions

Certain provisions of the Act had retrospective effect, backdated to 23 June 1998. From that time no person[70] may at any time do anything to defeat the broadly defined purposes of the Act;[71] no person is entitled to compensation from the government for any loss, damage or taxation liability arising from the Act;[72] and the enforcement and penalty provisions of the Act apply.[73] The provision in section 69 disallowing compensation for any real or perceived damage or loss, or any tax liability arising out of the operation of the Act, has provoked considerable debate and will be discussed in the following section.

B Ownership Split for Energy Companies

Ownership separation is the crux of the reform.[74] The legislative approach to ownership separation involves a two-stage process. Vertically integrated power companies must

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[70] A "person" is a natural person or a legal entity and includes the trustees of a trust acting in that capacity.

[71] Electricity Industry Reform Act 1998 ("EIR Act"), s 68.

[72] EIR Act, above n 71, s 69.

[73] EIR Act, above n 71, ss 47-59.

[74] EIR Act, above n 71, Parts 1 to 5 provide for the separation of electricity lines and supply for the purposes set out in section 2(2):

choose which business they will continue to be involved in. The Act requires the assets of electricity businesses to be classified into either:

1) an *electricity lines business*, which is a business that conveys electricity by line in New Zealand and which includes the ownership or operation, directly or indirectly, of electricity lines in New Zealand or any other core assets of an electricity lines business;[75] or

2) an *electricity supply business*, which is a business that sells or generates electricity, sells financial hedges for electricity price risks, or that trades in rights to sell or generate electricity in New Zealand. A supply business includes[76] the ownership or operation, (directly or indirectly), of an electricity generator in New Zealand or any other core generation assets;[77] and the ownership or operation (directly or indirectly) of any core assets of an electricity retail business. The core assets include the customer database, the benefits of contracts to sell electricity, and the benefits of non-competition undertakings.[78]

Exemptions to what constitutes an electricity supply business are provided for in section 5(2) for minimal volumes (selling or generating less than 2.5 GWh per annum), own or local consumption and independence from the national grid.

In its first reading, the Electricity Industry Reform Bill provided that persons selling or generating less than 0.5 GWh per annum were exempt from the definition of electricity supply businesses. Several small communities, including Haast, Milford, the Chatham Islands and Stewart Island opposed this provision in the Select Committee hearing.

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(2) The particular purpose of Parts 1 to 5 (separation of lines and supply) is -
(a) To prohibit certain involvements in electricity lines businesses and electricity supply businesses which may create incentives or opportunities -
(i) To inhibit competition in the electricity industry; or
(ii) To cross-subsidise generation activities from electricity lines businesses; and
(b) To restrict relationships between electricity lines businesses and electricity supply businesses which may not otherwise be at arms length.

[75] EIR Act, above n 71, s 4(1)(a),(b).
[76] EIR Act, above n 71, s 5(1)(a).
[77] EIR Act, above n 71, s 5(1)(b).
[78] EIR Act, above n 71, s 5(1)(c).

Haast Electricity submitted that the measures proposed by the Bill were inappropriate and that the company should be exempt from this definition.

The company gave various reasons for this submission:[79]

> "The Haast electrical network is remote from the national grid ... there is little or no likelihood of the Haast network ever being connected to a grid or other incoming supply ... The company services its 216 customers with approximately 80 kilometres of aerial transmission line. The primary source of energy production is the Turnbull Hydro Electric power station which is capable of generating a maximum of 890 kilowatts ...Annual energy distribution is currently averaging 2.5 GWh - well above the threshold published in the Electricity Industry Reform Bill."

Rather than provide exemptions for specific power companies in the Act, the result of the submissions made by these small communities was that the minimum sale and generation volumes were increased.

1 Interim Exemptions to Compliance with Ownership Separation

A series of interim exemptions means that immediate compliance with the ownership separation rules is not necessary in relation to certain existing and new arrangements.

Section 30 forbids the expansion of cross-involvements prohibited by the ownership separation rules. However, sections 28 to 45 of the Act provide interim exemptions, rules and specific options for complying with the ownership separation rules. These apply over a five-year transitional period:[80]

a) Section 28 allows a person to be exempted until 1 January 2004 from the ownership separation rules for existing cross-involvements (corporate separation must still occur);

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[79] Haast Electricity Submission to the Commerce Committee on the Electricity Industry Reform Bill, 2 June 1998, 2-3.
[80] EIR Act, above n 71, s 2.

b) Section 29 provides an exemption until 1 January 2004 for acquisitions of all or part of one person's cross-involvement by a person with no interest in an electricity business;

c) Section 31 provides an exemption for expanding cross-involvements in a single unseparated electricity business, provided the exempt person has no involvement in any other electricity business;

d) Sections 32 and 33 provide exemptions for Treaty of Waitangi related matters and section 34 exempts companies with direct ownership; and

e) Section 35 provides an expansion option until 1 July 1999 for a person that wishes to expand that person's involvement in one or more electricity companies before ownership separation.

The transitional provisions are likely to be contentious. For example, section 35 is intended to give companies flexibility in divesting their current involvements, and to provide incentives for early compliance with the ownership provisions by persons taking this option. However, it is an onerous requirement because such persons must by 1 July 1999 meet the ownership separation rules, or sell down to the level of involvement that existed as at 23 June 1998. In addition, the transfer of interests must be completed by 1 April 2000. Parties wishing to take advantage of this opportunity must notify the Commerce Commission.[81]

One example of the problems inherent in the section 35 time requirement became apparent in September 1998. On 25 September 1998 three power companies - Powerco, CentralPower and TrustPower - stated they would not proceed with a proposal to merge their generation and energy retailing businesses into a new company, National Power, as had been announced on 25 June 1995.[82] According to Mr Bradford:[83]

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[81] EIR Act, above n 71, s 35(1)(e),(f).
[82] James Weir "Merger Creates Giant Power Company", *The Dominion*, Wellington, New Zealand, 26 June 1998, 15.
[83] "Bradford response to Powerco-Central Power Statement", media release, 24 September 1998.

> "It is not correct to say that late changes to the Electricity Industry reform Act mean power companies must ownership separate their lines and retail/generation businesses by 1 July 1999. Firms still have until the end of 2000 to do this if they choose to do so. Power companies are only required to ownership separate by 1 July next year if they expand through mergers and takeovers in the meantime. While this requirement did apply to the National Power proposal, it has not stopped other companies getting on with the job."

C Two Stage Separation Procedure

The interim exemptions are removed in accordance with a two-stage procedure for separation:

1) by 1 April 1999 electricity companies must achieve *corporate separation* (electricity lines business and electricity supply business must be carried on by different companies). Electricity trusts must implement mirror trust separation by this deadline.

2) by 1 January 2004 (a five-year period in which to achieve compliance) electricity companies must achieve *ownership separation*. No company may be "involved" in both businesses, and companies must elect either to adopt a mirror trust option for ownership (each business is to be owned by community trusts, each with the same beneficiaries), or to dispose of one of the businesses. However, electricity trusts that have implemented mirror trust separation by 1 April 1999 are exempt from this deadline and may continue in a state of mirror trust separation indefinitely, provided they comply with the Act.[84]

1 The First Deadline - 1 April 1999

There are two possible options for compliance with the first stage of ownership separation - mirror trust separation and corporate separation. Both options are subject to the Arms Length Rules found in Schedule One of the Act.

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[84] EIR Act, above n 71, s 43 subject to s 45.

(a) Arms Length Rules[85]

Section 25 of the Act allows a company to carry on its electricity lines business and electricity supply business in different companies but with common ownership until 1 January 2004 - provided that the two businesses are operated entirely separately. The arms length rules take effect over a 12 month phase-in period beginning on 1 April 1999,[86] and amount to a de facto ownership split for the transition period prior to sale.

In essence, the Arms Length Rules:[87]

i) prevent a lines business giving the formerly associated energy business any preference and vice versa;[88]

ii) prevent a lines business discriminating against the competitors of the formerly associated energy business in favour of the formerly associated energy business and vice versa;[89]

iii) require directors and managers of the lines business to have regard to the interests of their own business only, and not those of the formerly associated energy business, and vice versa;[90]

iv) require separate management of the lines and energy businesses;[91]

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[85] The Arms Length Rules regulate all direct or indirect relationships, dealings and transactions between electricity supply businesses and electricity lines businesses. The Arms Length Rules are contained in a schedule to the Act and may be amended by governmental regulation if necessary.
[86] EIR Act, above n 71, s 26.
[87] EIR Act, above n 71, Schedule 1.
[88] EIR Act, above n 71, Schedule 1, cl 2(3).
[89] EIR Act, above n 71, Schedule 1, cl 2(4).
[90] EIR Act, above n 71, Schedule 1, cl 2(6).
[91] EIR Act, above n 71, Schedule 1, cl 2(7).

v) prohibit disclosure of information "that could put (the other business) in a position of material advantage in relation to any competitor or potential competitor" (if separate ownership);[92]

vi) require a register of dealings between the lines and energy business.[93]

(b) Practical Complications Resulting from the Arms Length Rules

As power companies endeavour to meet these requirements, the effect of the Arms Length Rules on system integration, on the definition of accountabilities and liabilities, and on supply security to consumers, is potentially serious. The most significant problems are likely to result from the information flow restrictions. Impeding data flows may operate to prevent one half of an existing power company making the other half aware that energy traders are having trouble maintaining local system balances, or that certain customers should be turned off or cut back to prevent black-outs.

Other problems may arise from the unrealistic time frame set to achieve arms length separation. Separating two highly integrated electricity businesses is likely to be a complex and time-consuming task. The twelve months lead in time to full arms length allowed for in section 26 is an improvement upon the six months initially proposed in the Bill, but it is arguably still an unrealistic time constraint. It may pressure businesses to establish structures to comply with the arms length rules by the required date, but that might not be in the best interests of the business or its shareholders.

In addition, the arms length rules in the Act are silent on the issue of sharing of premises between energy and lines businesses. Related businesses may continue to share premises, increasing the risk that the Act's objectives will be undermined. For example, the senior management for the two businesses could work from a common office, which would clearly introduce a higher risk of discriminatory behaviour by the lines business towards the "associated" energy business. Although physical separation

[92] EIR Act, above n 71, Schedule 1, cl 2(11).
[93] EIR Act, above n 71, Schedule 1, cl 2(12).

is desirable, it will be difficult for many power companies, especially smaller entities, to achieve.

(c) Mirror Trust Separation

An existing trust that had a cross-involvement in an electricity business as at 23 June 1998, and that is either a customer trust or a community trust or both, may by 1 April 1999 establish a new trust (a "mirror trust") to hold the interests of the settling trust - in either the electricity lines business or the electricity supply business.[94]

If the mirror trust option is selected, energy companies will effectively clone their existing trust deed and both trusts will have essentially the same beneficiaries. One trust will hold the lines business and the mirror image trust will hold the energy business. The ownership separation rules are arguably more onerous for electricity trusts than for other owners. Although the transitional provisions of the Act allow for ownership separation of electricity companies to be delayed until 1 January 2004, section 39 requires a mirror trust to "enter into a binding written contract to acquire all or part of the interests in or assets of the electricity lines business or electricity supply business from the settling trust or any company in which the settling trust is involved" by 1 April 1999. The transitional provisions do not apply to electricity trusts and ownership separation is not required.

Electricity trusts are required to follow a prescribed scheme for the implementation of mirror trust separation. Existing electricity trusts must:

i) Establish a mirror trust, which involves the duplication of the existing electricity trust (the settling trust) to form a new trust (the mirror trust);[95]

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[94] EIR Act, above n 71, s 37.
[95] EIR Act, above n 71, s 37.

ii) Use a mirror trust deed that complies with the Act (and make any necessary adjustments to their own trust deed). The mirror trust deed must have terms "as near as they may reasonably be" to the terms of the existing trust deed;[96]

iii) Appoint trustees for the mirror trust that are different from the trustees for the settling trust and who are not otherwise "involved" in both trusts;[97]

iv) Classify the assets of the electricity business into an electricity lines business and electricity supply business;[98]

v) Settle one of the businesses from the settling trust to the mirror trust so that the electricity lines business and electricity supply business are held by different trusts;[99] and

vi) Ensure both trusts comply with the Arms Length Rules.[100]

If the separate trusts contravene the Arms Length Rules,[101] the mirror trust exemption ceases absolutely and the separate trusts must immediately achieve ownership separation.[102] A defence is provided for technical and immaterial contraventions where the offending person is unaware of the contravention and then remedies it as soon as practical after having become aware of it.[103]

(d) Corporate Separation

Corporate separation means that electricity lines businesses and electricity supply businesses must exist in separate companies.[104] However, common ownership or "cross-involvements" between the two companies may be retained.

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[96] EIR Act, above n 71, s 41.
[97] EIR Act, above n 71, s 41(1).
[98] EIR Act, above n 71, s 37(1), s 39(2).
[99] EIR Act, above n 71, s 39(2).
[100] EIR Act, above n 71, s 38(2).
[101] See text at footnote 87.
[102] EIR Act, above n 71, s 45(1),(2).
[103] EIR Act, above n 71, s 45(3).
[104] EIR Act, above n 71, s 24.

Existing integrated energy companies must implement a corporate split of the lines and energy businesses by 1 April 1999, but the companies will have until 1 January 2004 to achieve a full ownership split (sale of one of the businesses). Ownership separation must occur at some stage before 1 January 2004. Once ownership separation has occurred it is not possible to return to corporate separation.

2 *The Second Deadline - 1 January 2004*

Subject to certain interim exemptions, ownership separation is achieved and enforced via certain rules and specific options for compliance. The main rules are:

i) *Section 17*: the cross-ownership prohibition;

ii) *Section 18*: the 20 per cent aggregate cross-ownership prohibition; and

iii) *Section 20*: the non-specific interests rule.

(a) General Cross-Ownership Prohibition[105]

The section 17 cross-ownership prohibition is the most important requirement of the ownership separation rules. The key concept that drives the continuation of separation of the two businesses is that of "involvement". Where a person is "involved" in an unseparated electricity business, the person is involved in both an electricity lines business and an electricity supply business.

The definition of "involved" in section 7 encompasses three levels:

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[105] EIR Act, above n 71, **s 17. Cross-ownership prohibition -**
(1) No person involved in an electricity lines business may be involved in an electricity supply business.
(2) No person involved in an electricity supply business may be involved in an electricity lines business.

i) *Direct involvement.*

This includes owning or operating any of the core assets of the business,[106] alone, together with an associate, or as an agent.[107]

The definition of "associate" is found in section 12. It covers the directors of bodies corporate; related body corporates and their directors; spouses or children; persons "living together in a relationship in the nature of marriage"; partners under the Partnership Act 1908; and persons acting in joint ventures, among others.[108]

ii) *Exceeding the 10 per cent threshold of voting rights or equity return rights in the business.*[109]

The 10 per cent threshold is exceeded in two situations. First, where a person holds more than 10 per cent control rights in the other business. Control rights are voting rights or rights to obtain or exercise voting rights, such as shares, options, convertible notes and proxies. Secondly, where a person holds more than 10 per cent equity return rights, namely rights to receive distributions, profits and rebates, and includes benefits derived directly or indirectly referenced to capital, residual economic value and profitability. It also includes rights to receive returns as trust beneficiaries.

There is no relativity in the definition of "involved". A 10 per cent interest in one business that has 15,000 customers may be significantly different from a 10 per cent interest in a business with 250,000 customers. Notwithstanding this, each interest is subject to the same provision.

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[106] EIR Act, above n 71, s 7(3).
[107] EIR Act, above n 71, s 7(1)(a).
[108] EIR Act, above n 71, ss 12(1)(a)-(g).
[109] EIR Act, above n 71,, s 7(1)(b).

iii) *Having material influence over the business by carrying on, or by managing a person carrying on, the business or by being a person.*[110]

Material influence embraces persons who do not breach the 10 per cent threshold but still have material ability to influence business. Managers, trustees, councillors and directors will all have material influence. Material influence is defined widely to include shareholders when acting as directors and associates.

(b) Statutory Exemptions to Cross-Ownership

Section 19 of the Act provides certain exemptions to the scope of application of the ownership rules. Exemptions are granted to lenders, sharebrokers and their proxies; where the business, involvement or interest is exempted by the Commerce Commission under section 81; or where the interest is declared, by regulations made under the Act, to be a disregarded business, involvement or interest.[111]

For example, banks will be protected from direct liability under the Act arising from their commercial lending activities with New Zealand electricity businesses pursuant to section 19(1)(a). Section 19 provides that no account may be taken of the bank's involvement or interest in an electricity business where the ordinary business of the bank consists of, or includes, the lending of money; and the bank has the involvement or interest only as a result of security given to the bank for a loan or guarantee entered into in the ordinary course of business of the relevant electricity business; or enforcing that security.

The Act will not apply directly to the bank by way of the bank's commercial lending activities with the electricity business. The application of the Act is based on a person's "involvement" in an electricity business. It will be important for banks and sharebrokers to remain within the parameters of the section 19(1) exceptions and to

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[110] EIR Act, above n 71, s 11(1)(a).
[111] EIR Act, above n 71, s 87(1)(a) and (b).

meet the relevant conditions, such as the test of acting "in the ordinary course of business".[112]

(c) Problems Inherent in the General Cross-Ownership Prohibition

The ban on cross-ownership in section 17, coupled with the strict ban on "material influence" and "association" could, over time, cause a large number of ordinary New Zealanders and New Zealand companies to unwittingly break the law, because they will find themselves, through legacies, endowments, mergers or even "a relationship in the nature of marriage" in breach of the government's requirements.[113]

(d) 20 per cent Aggregate cross-ownership prohibition

A person who is involved in an electricity supply business may not acquire interests in an electricity lines business if that person, together with any other number of persons who are involved in the supply business, would then in aggregate:

1) hold more than 20 per cent of the equity return rights or control rights in that lines business;[114] or

2) have material influence over that lines business.[115]

The rule applies inversely to persons involved in electricity lines businesses. Only those investors who are "involved" in a supply business are included in a calculation of whether the aggregate 20 per cent threshold in lines or supply business has been exceeded. Existing holdings that exceed the 20 per cent aggregate level must be

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[112] See, for example *Countrywide Banking Corp Ltd v Liquidator Of CB Sizzlers Ltd; Countrywide Banking Corp Ltd v Dean* (1998) 8 NZCLC 261,509; [1998] 1 NZLR 385; Modern Terrazzo Ltd (in liq), Re ; Bowden & Ors v Macdonald & Anor [1998] 1 NZLR 160, (1997) 8 NZCLC 261,478.
[113] EIR Act, above n 71, s 12(1)(c).
[114] EIR Act, above n 71, s 18(2)(a).
[115] EIR Act, above n 71, s 18(2)(b).

reduced by 1 January 2004.[116] If the parties involved cannot reach agreement they must follow a compulsory pro rata sell-down to the 20 per cent threshold.[117]

The Act provides no guidance as to how electricity companies or investors themselves are to monitor whether the 20 per cent aggregate cross-ownership prohibition has been breached. A listed company is able to obtain certain information about its own shareholders through the substantial security holder notice provisions in Part II of the Securities Amendment Act 1988.[118] However, this does not extend to information about a shareholder's "associates",[119] nor to details of a shareholder's other investments. Therefore, most purchasers of shares, as well as the electricity companies themselves, will be placed under an impossible obligation. None of these persons will know whether the acquisition of a parcel of shares in a supply company or a lines company will bring about a breach of section 18, because they will be unaware of what other cross ownership situations already exist.

(e) Non-specific interests rule

The purpose of this rule is to ensure ownership separation is required of trust-like entities where there are significant levels of membership in both electricity lines and electricity supply businesses. The number of beneficiaries must not overlap by over 20 per cent between two trusts holding different types of electricity businesses.[120] The Act also prohibits beneficiaries of a trust holding one type of electricity business from having more than a 20 per cent overlap with the shareholders in the other type of electricity business.

Mirror trust separation is exempted from the non-specific interests rule.[121] An exemption is also possible for widely-held companies breaching the 20 per cent overlap

[116] EIR Act, above n 71, s 36(1),(2).
[117] EIR Act, above n 71, s 36(5).
[118] Securities Amendment Act 1988, Part II.
[119] See text at footnote 108.
[120] EIR Act, above n 71, s 20
[121] EIR Act, above n 71, s 43.

if no one in the overlap is "involved" in the widely-held company.[122] This exemption allows community trusts or other trusts to set up a company and transfer one type of business to that company, and to vest the shares in the company in their community or beneficiaries, even when there will be an overlap.[123]

D ECNZ Split

Part 8 of the Act concerns the split of ECNZ into 3 baby State-owned enterprises (SOEs). Based on current forecasts, this should give rise to a generation market with the following market share in 2002:[124]

a) SOE 1 (Waikato hydro): 13 per cent

b) SOE 2 (Huntly thermal, Te Awamutu thermal, Tongariro hydro): 17 per cent

c) SOE 3 (Manapouri and Waitaki hydro) 30 per cent

d) Contact (Clutha hydro, Wairakei and Ohaaki geothermal, oil and gas fired thermal) 25 per cent

e) Private (gas fired thermal, small hydro) 15 per cent

Pursuant to section 98, at any time before 1 April 2000 ECNZ's Shareholding Ministers may direct that assets and liabilities of ECNZ, or of any wholly-owned subsidiary of ECNZ, be transferred to any one or more State enterprises. The directors of ECNZ must comply with that direction and are relieved from any liability that could arise by virtue of compliance with that direction.[125]

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[122] EIR Act, above n 71, s 34.
[123] Energy Markets Policy Group *Electricity Industry Reform Act 1998: Ownership Options* (Ministry of Commerce, July 1998) 7.
[124] Hon Winston Peters, Treasurer; Rt Hon Bill Birch, Minister of Finance; Hon Max Bradford, Minister of Energy "A Better Deal For Consumers. Electricity Reforms" (media release, 7 April 1998), 2.
[125] EIR Act, above n 71, s 98(1)(a).

The mechanics of the ECNZ split are not specified in the Act, but are being dealt with by an Electricity Reform Transition Unit ("ERTU"). ERTU's role is to design the configuration of each of the new State generators and the transactions that will be required to establish them as viable businesses. In September 1998 ERTU reported to ECNZ's Shareholding Ministers that the split of ECNZ into three new SOEs would proceed to the next stage. ERTU found that the split would meet the government's objective of a more competitive electricity generation market. The report set out a detailed implementation plan for effecting the split, including the transfer of assets and existing contracts from ECNZ to the new SOEs, the transfer of staff, a financial structure and arrangements for ECNZ's debt management.[126]

On completion of the restructuring, certain existing restraints on ECNZ are to be removed. These include the cap on ECNZ providing more than 50 per cent of new capacity; the requirement for ECNZ to "ring-fence" any new capacity it provides; and the requirement for ECNZ to offer a high level of its capacity to customers each year on longer term contracts.[127]

E Role of Commerce Commission and regulation-making powers

Despite the framework for industry-specific regulation established by the Act, the Commerce Act continues to apply.[128] The Commission has power to exempt any business, involvement or interest from the application of the Act, or exempt any person from compliance with regulations made under the Act.[129]

The Act also gives the government extensive regulation-making powers under section 87. Regulations may be promulgated for the following purposes:

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[126] "ECNZ Split - Another Step Closer to Lower Prices" (media release, 15 September 1998).
[127] See text at footnote 22.
[128] EIR Act, above n 71, s 82.
[129] EIR Act, above n 71, s 81(1), s 87(1)(a),(b).

1) to classify assets and activities in relation to the definitions of "electricity lines business" or "electricity supply businesses";[130]

2) to provide for disclosure of involvements or interests in electricity businesses;[131]

3) to provide such anti-avoidance measures as are necessary to ensure that the purposes of the Act are not defeated (this "catch-all" provision permits regulations to be made in relation to a broad range of matters);[132]

4) to alter the Arms Length Rules;[133] and

5) to provide for a number of administrative matters.[134]

Section 88 also provides for regulations to be made to restrain line charges for domestic and rural consumers. These regulations do not apply to charges relating to the national grid, however. Price restraint may involve control over the amount of the charge or any component of the charge; the frequency of the charge or component of the charge; or the increase in the charge. The Act is silent as to the form of price control that the government may adopt.

During the select committee process, there was considerable concern among consumer groups that lines businesses would be under pressure to allocate costs where they fell, and that they would not be able to average costs between large and small consumers. Consumer groups feared that lines networks would charge the actual costs of using their networks, thereby lifting the price of delivered electricity to small and rural customers.[135] Section 88 met this concern by reintroducing an expired provision from

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[130] EIR Act, above n 71, s 87(2)(a).
[131] EIR Act, above n 71, s 87(2)(f).
[132] EIR Act, above n 71, s 87(2)(g).
[133] EIR Act, above n 71, s 87(2)(h).
[134] EIR Act, above n 71, s 87(2)(i)-(l). Administrative matters include the procedures and prescribed forms for applications and notices required under the Act, and prescribing the fees or charges payable under the Act and methods of assessing these.
[135] Doug Matheson, President Electricity Industry Supply Association of New Zealand "Poles Apart on Power Reforms" *The Evening Post*, Wellington, 23 June 1998,5.

the Electricity Act 1992. Section 63(1) of the Electricity Act 1992 allowed the Governor-General by Order-in-Council to regulate for the imposition of price restraint. This price control was in respect of electricity conveyed or supplied to domestic premises by electricity distributors or retailers, or both. It did not limit the Commerce Act's price control provisions in any way.[136]

Part 7 of the Act involves amendments made to the Electricity Act 1992. Section 95 provides for the insertion, after section 170, of a new section 170A, allowing regulations to be made to provide for a system or set of rules enabling consumers to choose and alternate between competing electricity retailers; requiring all users of the national grid or distribution lines to comply with a set of rules enabling such consumer choice; and exempting certain persons from this.

F Penalties for Contravention

The enforcement and penalty regime in Part 3 is modelled closely on the enforcement and penalty regime in the Commerce Act.

A contravention of the Act is defined broadly and includes anyone who has contravened a provision,[137] plus anyone attempting,[138] aiding, abetting,[139] knowingly concerned in a contravention,[140] or inducing someone else to contravene a provision.[141] This section will create potential difficulties for lawyers in the provision of advice - uncertainty will arise because of concern that commercial advice may breach the *purpose* of the Act, even if it meets the black letter requirements. A contravention may be enforced by any party, including competitors and the Commerce Commission.

A general defence is provided for inadvertent contraventions where a person did not know, and ought not reasonably to have known, of the contravention and the

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[136] Electricity Act 1992, s 66.
[137] EIR Act, above n 71, s 47(a).
[138] EIR Act, above n 71, s 47(b).
[139] EIR Act, above n 71, s 47(c).
[140] EIR Act, above n 71, s 47(e).
[141] EIR Act, above n 71, s 47(d).

contravention arose other than from that person's action. This defence expires three months after the person became aware of the contravention.[142]

The monetary penalties are tied into the Commerce Act. Pursuant to section 52(2) the maximum amount of the pecuniary penalty is the same as may from time to time be specified in section 80 of the Commerce Act in respect of each act or omission. That is, fines of up to $5 million for bodies corporate and $500,000 for individuals/directors. The court may also award three-times damages to penalise any commercial gain resulting from a contravention of Part 2 (Separation of Lines and Supply - Rules and Exemptions) or section 68 (Duty not to defeat purposes of Parts 1 to 5).[143] Alternatively it may grant injunctions[144] or order divestiture of assets or voting securities.[145]

VI ASSESSMENT OF IMPACTS OF THE ELECTRICITY INDUSTRY REFORM ACT 1998

A The New Regulatory Regime

The Electricity Industry Reform Act 1998 has dramatically altered the regulatory regime surrounding the New Zealand electricity industry. Light-handed regulation has been augmented by a structural change - ownership separation of natural monopoly elements from competitive businesses. A structural solution was viewed by the government as a preferable option to regulation in order to deliver the best outcomes to consumers.

The new electricity industry specific regulatory regime will comprise the following four key components:

1. ownership separation of natural monopoly (distribution and transmission) from competitive (retail and generation) electricity businesses;

[142] EIR Act, above n 71, s 48.
[143] EIR Act, above n 71, s 55(1).
[144] EIR Act, above n 71, s 52.
[145] EIR Act, above n 71, s 54.

2. the Commerce Act which is designed to prohibit and protect against anti-competitive behaviour and the acquisition or strengthening of market dominance;

3. The Electricity (Information Disclosure) Amendment Regulations 1998 which are intended to make transparent the operation of businesses in the electricity industry that have market dominance;[146] and

4. the threat of further regulation, including price control under Part IV of the Commerce Act, if market dominance is abused.

This section will assess the extent to which the Act is consistent with existing competition policy and economic (State sector) reform, including the general tenor of electricity industry reform. It will propose that while the structural solution adopted in the Act may achieve the government's stated objectives of lower prices for consumers and greater efficiency, this is attained by a new and drastic form of governmental intervention into private property rights - the requirement for compulsory divestment of assets without compensation.

B Is the Act Consistent With Competition Policy?

The Act is consistent with competition policy in that by providing a structural solution, it avoids the need for heavy-handed price control and also avoids the need for an industry-specific regulator to be established. New Zealand's small size does not lend itself to funding a large competition or regulatory authority.[147]

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[146] The tightened Electricity (Information Disclosure) Amendment Regulations 1998 were enacted to prevent companies departing from the specified standard values and lives and increasing their ODVs in order to hide monopoly profits. Companies are no longer allowed to exceed the standard asset values and lives specified in the Handbook for Optimised Deprival Valuation of Electricity Lines Businesses. For the purposes of disclosure, companies' lines business financial statements will be confined to their natural monopoly activities. This is intended to make it more difficult for companies to hide cross-subsidies by allocating inappropriate costs to their line businesses. The strengthened Regulations also require companies to disclose line charges on customer bills and to publish "user friendly" summaries of their disclosures (in addition to their full disclosure).

[147] Fenwick, above n 9, 18.

Latent in ownership separation will be a round of mergers and amalgamations which continue the trend towards rationalisation of the electricity industry introduced by the State sector reforms of the 1980s. However, mergers and amalgamations may create potential competition law problems as oligopolies of distributors and retailers establish themselves.

However, an industry-specific structural solution is contrary to the general scheme of the Commerce Act, which was intended to be generic legislation governing competition in all industries. It is conceivable that the introduction of specific legislation for the electricity sector could be seen as the start of a move away from reliance on the Commerce Act and light-handed regulation towards increased government involvement in all areas. It may trigger a burgeoning of industry-specific regulation in other areas of the economy, such as telecommunications or gas, and this would be anathema to the New Zealand Government's *laissez faire* approach to the economy.

1 Avoidance of Heavy-Handed Regulation?

(a) Price Control

The structural solution created by the Act is still backed by the Commerce Act, but the ability to impose price control has been strengthened. In addition to the threat of price control in Part IV of the Commerce Act, price control provisions have been enacted in Part 6 of the Act. This does not necessarily mean that price control will be exercised by the government. The legislation is not "heavy-handed", it is simply allows a more interventionist policy than New Zealand has previously adhered to, and it is an admission that unregulated monopolies will not always act in the public interest. The Commerce Act is fundamentally to promote efficiency, whereas the Act meets the concern that price increases might be inequitable to certain sectors of the community. According to the National Business Review:[148]

[148] John Small "Electricity Reforms Lack Any Measures To Control Prices", *National Business Review*, June 19, 1998, 18.

> "There is every reason to believe that the threat of official regulation is likely to be even less effective than the threat of competitive entry. This is especially true in New Zealand. The recent history of policies toward network industries is as far removed from price control as is conceivably possible. This means that if the threat of regulation is to have any credibility, it would have to address some of the specific problems that will be faced by regulators."

Despite providing for the threat of further regulation, the Act does not specify how often, or when, price control may be exercised. Section 88 of the Act provides that regulations relating to charges for line function services may be made "from time to time". It is likely that price control will be used where there is clear evidence of excessive costs or profits - in September 1998 Mr Bradford announced that officials are developing arrangements under which businesses whose prices are out of line will be under notice that price control will be imposed.[149] Therefore, the imposition of price control for a period will be a form of punishment for individual companies charging higher than average prices.

Nor does the Act specify the method by which the government may fix prices. It is possible that this was a deliberate move, revealing the government's continuing reluctance to rely on Part IV of the Commerce Act to regulate prices. Indeed, Mr Bradford claimed that regulating power prices has not worked in the UK or the US, and that these countries are now moving to require companies to sell generation or energy trading activities to develop competition.[150] Mr Bradford placed considerable weight on a comment made by the United Kingdom's Director-General of Electricity Supply that the problems identified with the integrated nature of public electricity supply businesses would be most easily resolved by ownership separation of supply and distribution.[151]

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[149] Max Bradford, "New Electricity Environment" *New Electricity Environment Conference* (Wellington, 7 September 1998).

[150] Chris Hutching "Bradford Presses On Energy Reform" *National Business Review*, June 12, 14.

[151] Above n 66, 9152: "...[O]nly last week the Director-General of Electricity supply in the United Kingdom - the industry regulator - issued a consultation paper that concluded that full separation of ownership of the supply and distribution in Britain would be desirable. In essence his conclusions are the same as ours."

It is arguable that Mr Bradford's comment demonstrates that the government will not control prices by regulation unless the ownership separation provided for in the Act fails to deliver lower prices. Price control is an extreme step for the government to take - it sends signals to the public that the government's existing regulatory (and structural) policy has failed.

Should the government be required to regulate pricing, it is submitted that the most favourable approach to price control is that adopted by the United Kingdom: RPI-X (Retail Price Index minus X). Under this model, natural monopoly lines companies are not allowed to increase the average price (or revenue) by more than a specified X factor, which is individually settled with the company, below the rate of inflation, as measured by changes in the Retail Price Index (RPI). This type of price control continues incentives for capital investment in the distribution network (that may otherwise be stifled by a heavy-handed regulatory environment), and incentives towards efficiency - companies are allowed to keep the gains from greater efficiency during the period of the price control. Provided that there is enough competition for supply to small consumers to keep prices, as distinct from costs, low the power companies will have a built-in cost cutting incentive.[152]

Researching, designing and implementing an effective price cap is a major task - one that risks being hampered by the lack of researchers in New Zealand experienced in regulatory design. Even after the details of the price control mechanism have been published, it is far from clear that the threat of its implementation will be sufficient to persuade network businesses it is in their interest to avoid regulation by reducing prices.[153] All price control poses difficulties, however. In the United Kingdom, the implementation of RPI-X regulation has been more complex than was anticipated.[154]

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[152] Michael C Brower, Stephen D Thomas and Catherine Mitchell "The British Electric Utility Restructuring experience: History and Lessons For the United States" in The National Council on Competition and the Electric Utility Industry *The Electricity Industry Restructuring Series* <http://eetd.lbl.gov/NationalCouncil/pubs/restdeba.html>,21.

[153] John Small "Electricity Reforms Lack Any Measures to Control Prices" *NBR*, 19 June 1998, 18.

[154] Barton, above n 24, 136.

(b) An Industry Specific Regulator

Industry specific regulators to monitor and enforce price control (and other non-price issues) are a hallmark of heavy-handed regulation. Unlike reform in the United Kingdom and Australia which established industry-specific regulators upon radical restructuring of public utility industries, New Zealand's restructured electricity industry will continue to rely upon the Commerce Act rather than on the monitoring capabilities of an electricity regulator.[155]

The former Chairman of the Commerce Commission has opposed the concept of industry-specific regulator for New Zealand, arguing that a single agency with responsibilities across the board, such as the Commerce Commission, allows for consistency between different sectors of the economy. Industry specific regulators are necessarily focused on a narrow set of issues and are constrained by jurisdictional limits tied to specific technology or services.[156]

Although industry-specific regulators may provide an independent, credible and accessible way of resolving consumer complaints, they have many disadvantages. By eliminating the need for an industry-specific body, the Act has prevented the following drawbacks arising in New Zealand:

i) reduced incentives on parties to resolve disputes. In countries where industry-specific regulators exist, businesses often focus their efforts on dealing with the regulator rather than competing with each other. Considerable time and money is spent on lobbying regulators and on avoiding, changing or complying with regulations;[157]

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[155] The Act has not created an electricity regulator, despite pressure for such a development in the select committee process. The Public Power Campaign's submission stated that: "New Zealand's refusal to provide for regulation is unprecedented world-wide and is becoming the subject of derision in some overseas publications, notably the Guardian Weekly ... An important comparison is with the privatised Victorian power industry - which Peter Troughton "fixed up" after giving up on New Zealand's wholesale electricity market experiment .... Victoria has an industry-wide regulator, created by statute, independent of Government and with standing consumer consultative committees."

[156] Dr Alan Bollard, above n 48.

[157] *Light Handed Regulation*, above n 40, 8.

ii) the biases, intellects and perseverance of regulators affecting the regulatory process. For example, in the United States, regulatory economist Alfred Kahn's enthusiasm for economically sensible pricing was a powerful force for rate restructuring in the electricity business, and his preference for competition hastened the demise of airline regulation.[158] Kahn argued that regulatory commissions, which were responsible for the continued provision and improvement of service, believe that it is more important to protect the health of the companies they regulate than the interests of customers. He said: [159]

> "[Regulatory commissions] come increasingly and understandably to identify the interest of the public with that of the existing companies on whom it must rely to deliver goods."

iii) taxpayers bearing the administrative costs of operating regulatory bodies, rather than those affected by the industry. It is unnecessarily burdensome to impose extra costs on taxpayers who already fund the Commerce Commission, even when the cost of running an electricity ombudsman has been estimated at approximately $200,000 per year, substantially less than the cost of maintaining the role of the Banking Ombudsman;[160]

iv) "regulatory capture"[161] by interest groups within the industry due to the development of close working relationships. Regulatory capture is less likely where there is a single competition agency for all industries and where the "regulator" believes that his or her performance will be judged to a large extent by success in promoting competition;

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[158] Irwin M Stelzer "Lessons for UK Regulation from Recent US Experience" in Professor M E Beesley (ed) *Regulating Utilities: A Time For Change* (Institute of Economic Affairs in association with the London Business School, London, 1996), 201.

[159] Alfred E. Kahn, "The Economics of Regulation: Principles and Institutions", *Vol. 2: Institutional Issues* (Cambridge, MA: The MIT Press, 1991), 12.

[160] Peter Farley, Wheeler Campbell Securities Limited "Consumer Monitoring Under a Light-Handed Regulatory Regime" in *Conference on Exploiting Opportunities and Future Developments in Electricity Rationalisation* (Institute for International Research, Wellington, 29 March 1995), 16.

[161] Colin Robinson "Profit, Discovery, Entry: The Case of Electricity" in M E Beesley (ed) *Regulating Utilities: A Time For Change?* (Institute of Economic Affairs in association with the London Business School, London, 1996), 135.

v) compliance costs arising out of distortions caused by imperfect regulation. Regulations that are not tailored precisely can fail to achieve their intended purpose, thereby causing unpredicted consequences, and regulators often face information and administrative lags in keeping the regulations in line with changing market developments;[162] and

vi) the tendency of regulatory bodies to take over business decision-making. For example, the Victorian Office of the Regulator-General has sole responsibility for issuing operator licences within Victoria's electricity supply industry.[163]

2 *Mergers and Amalgamations*

At present, distribution networks comprise the main asset base of existing power companies. In the wake of the Act, supply companies that have been forced by the Act to separate from their previously associated lines businesses, and which do not operate or own substantial generating capacity, will be companies with relatively few assets, other than buildings and meters. These smaller companies will have relatively weak balance sheet structures and will struggle to compete with those supply companies with more customers. This is unlikely to be the case with companies that have National Grid assets or major generating assets behind them.[164]

The Act is consistent with existing government policy in the pursuit of efficiency: lines and energy businesses will be forced into "horizontal" amalgamation,[165] with electricity retailers and suppliers merging or buying one another until the market stabilises into a lower number of medium-to-large competitors. The Electricity Supply Association of

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[162] *Light Handed Regulation*, above n 40, 8.
[163] *Light Handed Regulation*, above n 40, 8.
[164] Graeme Speden, "Whither the Electricity Industry Reforms" *The Independent*, 1 April 1998, 17. At July 1998 New Zealand had 37 energy companies. Twenty of them had generation assets. These generation assets comprise 40 hydro dams (the majority of which have been long-since paid for and which are not subsidised; their operating costs are minimal), 3 geothermal stations, 3 landfill gas generators, and 2 large combined cycle gas-fired stations, adding up to over 1,100 MW of capacity.
[165] William G Shepherd *Market Power in the Electricity Industry* (1997) National Council on Competition in the Electric Industry <http://eetd.lbl.gov/NationalCouncil/pubs/mktpower.pdf>, 4.

New Zealand estimates that 10 or fewer separate lines and energy companies will form - in effect an oligopoly of lines or energy companies - so that the minimum viable consumer base will be 400,000.[166]

The government is correct in questioning the justification for the duplication in assets and costs in electricity lines businesses: in New Zealand the five largest power companies supply only half of the population. The largest company, Mercury Energy, has 243,000 customers. Twenty power companies have less than 25,00 customers, with the smallest, Buller Electricity, having just 4,000 customers.[167] These figures do not compare favourably with the United Kingdom and Australia. The United Kingdom's East Midlands distribution company has 2.8 million customers and Energy Australia has 1.6 million consumers.[168] According to the Ministry of Commerce, there is the potential for efficiency gains - through mergers of power companies - of between $40 million and $100 million per annum if all companies are as efficient as the leading ones.[169]

However, horizontal market power is the ability of a dominant firm (or firms) to control production and therefore manipulate prices - specifically to restrict output, thereby raising prices. It arises as a firm's market share increases in relation to the boundaries of the relevant overall market. This is of most concern for lines businesses, which will also merge into larger entities. The pressure on lines businesses will not be competitive, because they are natural monopolies. Instead they will be under regulatory, commercial and public pressure to keep their costs and prices down. It is arguable, therefore, that horizontal market power will itself create conditions that stifle competition - a direct affront on the policy behind the Act, and on competition law and policy in New Zealand.

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[166] Mark Reynolds "Merger to Create Biggest Ever Energy Retailer" *New Zealand Herald*, 25 June 1998, 12.
[167] Max Bradford, "New Electricity Environment" *New Electricity Environment Conference* (Wellington, 7 September 1998).
[168] Above n 167.
[169] Above n 66, 9152.

C *Is the Act Consistent With the Thrust of Economic Reform?*

The Act is seen by some in the electricity industry to represent a reversal of the previous decade of gradual government withdrawal and to start back down the road to re-regulation. It also moves away from the corporate separation structures utilised in the State sector reforms (for example, in corporatisation), but this should not be viewed as problematic. If a system is shown to be ineffective, it should be changed.

Compulsory divestment of lines and energy businesses will have a twofold effect on electricity companies. First, State-owned generating companies will progressively move into retail business. Secondly, privatisation of ECNZ is foreseeable. It is submitted that the reforms provided for in the Act are nonsensical in the absence of privatisation of the SOE generators.

1 *State-Owned Generators Will Move Into Retailing*

The Act appears to allow one rule for the State and another for the private sector - the policy considerations requiring divestment in the interests of competition and lower prices for consumers have not been applied equally to private power companies and to the State. For example, the Act provides for 100 per cent government ownership of lines and energy businesses left intact while forcing divorcement of power company owned line and energy activities; and for generators to build or buy their own lines businesses provided that these are in competition with existing privately-owned lines.

In addition, the policy of distancing the Crown from commercial ventures has been replaced by two provisions in the Act that allow an increased number of State-owned generators to move into electricity retailing. The first is section 16:

> **16. Act binds the Crown** – (1) This Act binds the Crown except as provided in subsection (2).
>
> (2) This Act does not apply to the Crown in so far as this Act applies, or would apply, to the Crown's involvement in both a business that operates all or part of the national grid and in an electricity supply business.

In addition there is provision which allows for a supply company to be in generation as well as supply. This enables Crown owned generation companies to buy electricity suppliers. Such companies, because of their size and financial backing, will have a significant advantage over other supply companies because there is no provision in the legislation to prevent them cross-subsidising their supply operation by their other activities.

> **5. Meaning of "electricity supply business"** – (1) For the purposes of this Act, "electricity supply business" –
>
> (a) Means a business that -
>
> (i) Sells electricity in New Zealand:
>
> (ii) Sells financial hedges for risks relating to the price of electricity in New Zealand:
>
> (iii) Generates electricity in New Zealand:
>
> (iv) Trades in rights to sell or generate electricity in New Zealand

The combined effect of sections 16 and 5 allows generators to build or buy lines that compete with existing lines, without lines businesses having comparable rights to own generators. This asymmetry will provide a mechanism for driving down the costs of supplying SOE end-use customers, at the expense of other network users.

While the ability for Crown owned enterprises to compete for supply will introduce more competition into the industry, this ability will not be on the basis of a level playing field and could be detrimental to the viability of many supply companies. In particular, the SOEs are likely to target major users of electricity and offer bilateral contracts, bypassing the wholesale electricity market. This may be beneficial to large users but not to smaller consumers. The result will be a segmentation of the market into generator and non-generator customers, with the latter being supplied from a short-term market, which the SOE generators dominate, while the former shelter behind bilateral long-term contracts.

The break-up of lines and energy businesses will destabilise the hedging market.[170] Few divested energy traders will have the financial substance (without support from their lines parent) to take long-term hedge positions. It is likely that the SOE generators alone will be best able to hedge prices in order to secure their future prices against market volatility and shortage of supply. Power companies will cope with the problem of divesting energy operations that have ongoing hedge liabilities by selling the entire energy business to one or other of the SOE generators. Those SOEs that take advantage of divested energy businesses will operate at a significant commercial advantage to energy companies that choose to operate alone or as merged entities because of their knowledge of the hedge market and detailed knowledge of power companies' current retail pricing arrangements. It is arguable that this will create another dynamic to promote the take-over of the industry by the four SOE generators.

2 *Privatisation of ECNZ*

If the four baby ECNZs dominate the energy market as a result of the Act, future governments will again face the problem of being both regulator and investor, an irony when one considers the thrust of economic reform in New Zealand towards rolling back the State from interference in commercial activity. There are several reasons why the additional split of ECNZ only makes sense if the government is committed to privatisation of the remnants of ECNZ:

a) Four baby ECNZs competing in the same business are likely to cause serious damage to each other in terms of their market share and profitability. This will strain the relationship of each Board of Directors with the Minister who is likely to be responsible for all four of the new SOEs.[171]

b) The State by its nature will be seen as a "soft touch", on the one hand by interest groups opposed to new generation ventures and on the other by industries

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[170] See text at footnote 24.
[171] Barton, above n 20, 136.

promising jobs and growth if they can get government assistance with consents or with prices;

c) While the government is dominant in the generation industry there may well be a perception that vigorous competition is unlikely to occur and there may be reluctance by investors to invest in future generation projects. The only realistic option is for the government to privatise its State-owned generators;

d) Privatisation would be consistent with the tenor of the State sector reforms. It is widely perceived that corporatisation, which partially replicates private sector competitive conditions, is merely an interim step towards full privatisation.[172] Further, privatisation takes another step towards removing cross-subsidisation and improving the accountability and commercial performance of the generators SOEs. Indeed, power companies and previous Ministers of Energy, along with other senior ministers, have consistently agreed that the State is not the appropriate body to maintain power supply into the next century:

> "The appropriate approach to energy issues is to provide a commercial environment with commercial incentives in which those who know the industry best can use their knowledge to respond flexibly to the various risks that inevitably arise. That is much more likely than a centralised bureaucratic arrangement to result in a system that balances the low-cost supply with a reasonable level of security supply."[173]

> "Private investors are in a position to respond far more quickly to avert possible power shortages and there is no need to invest public money and power stations now that may not be needed until well into the next millennium."[174]

> "I should stress that I want to see private sector investors as the main providers of new capacity. The Government has better things to do with taxpayers' money than sink it into power projects."[175]

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[172] Ian Duncan and Alan Bollard *Corporatization and Privatization: Lessons From New Zealand* (Oxford University Press, Auckland, 1992), 33.
[173] Above n 66.
[174] Hon Doug Kidd, media release, 16 August 1996.
[175] Hon Jenny Shipley, April 1997, in ECNZ *Electricity Under the Microscope* (1997), 7.

e) The Coalition Agreement 1996 specifically ruled out the sale of ECNZ, Contact Energy or Trans Power. It is not clear in the Act whether the Coalition Agreement would cover the baby ECNZs created from the break-up of their parent, but the inference is that only ECNZ, Contact and Trans Power, as they stood in 1996 would be exempt from privatisation policies.[176] The new entities would fall outside the Coalition Agreement; and

f) Finally, the movement of the baby ECNZs into retailing through the purchase of local energy companies that have been forced onto the market will improve their capital structures and enhance their desirability to investors.

Rather than move the State back into heavy interference in the electricity industry, with the attendant weaknesses and problems of State involvement,[177] the government would be wise to set in place total privatisation of its generators by public share float. If the privatised entities perform adequately in providing competition and lowering wholesale electricity prices, they are unlikely to face the lack of goodwill often engendered by recently privatised industries.[178]

D Infringement of Private Property Rights

"There can be no more heavy-handed regulation than forcing owners of assets to divest".[179]

The ownership separation proposals represent a new and intrusive form of government intervention in private corporate business that does not fit the existing mould of economic or competition regulation. Forced divestment of assets, regardless of

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[176] Ross Burrell "Splitting Headaches" (1998) *The Power* <http://www.burrell.co.nz/thepower/ecnz.htm>.
[177] See text at footnote 14.
[178] F Fukuyama "The End of History and the Last Man" in John Kay "The Future of UK Regulation" in M E Beesley (ed) *Regulating Utilities: A Time For Change?* (Institute of Economic Affairs in association with the London Business School, London, 1996), 157. The issue of legitimacy is never in doubt in nationalised industries, as it can be in the private sector. According to F Fukuyama: "The strength of legitimate government is that it enjoys a reserve of goodwill which protects it when things go badly".
[179] David J Teece and Christopher J Pleatsikas "New Zealand Electricity Reforms: An Economic Analysis of Impacts" in *Power New Zealand Submission to Commerce Committee on Electricity Industry Reform Bill* (Power New Zealand, Auckland, 8 June 1998), 11.

resulting loss and expressly barring compensation for such loss, is unprecedented and can be contrasted with other statutory measures that have enacted significant structural and regulatory reform.[180] The Act interferes with contractual rights and creates uncertainty for future investment and the security of property rights in New Zealand. For the purposes of this section of the paper, "property" covers every type of property that is affected by the Act, including shares and obligations in reliance on ownership of shares or assets.

1 Value Loss to Company Shareholders and Trust Beneficiaries

Major value in existing power companies derives from vertical integration - the fact that power companies control lines, (generation, in some instances) and retailing businesses. Ownership separation requires that retail and generation assets must be divested from lines businesses. As indicated in the previous paragraphs, it is foreseeable that retail and generation businesses will be sold by power companies because they lack a viable asset base. It is likely that as the 1 January 2004 deadline for ownership separation approaches, many divested retail and generation companies will be forced onto the market. Considerable "value loss" will be incurred, depending on the market price achievable for the business to be sold at the time the sale is effected. "Fire sales" will provide a windfall gain to the purchasers of the businesses at the expense of existing shareholders (resulting in wealth transfers to foreign investors where the purchasers are overseas companies).

Power companies will face value loss regardless of their ownership structures. For example, trusts will be disadvantaged in opting for either mirror trust separation or full ownership separation. Where a mirror trust is established before 1 April 1999, the beneficiaries of the trust will not suffer value loss simply because control of lines and energy is in two separate trusts. They will, however, suffer the costs of establishing a duplicate trust by 1 April 1999 and face the additional threat that if this deadline is not

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[180] Compare, for example, the Energy Companies Act 1992, the Health Reforms (Transitional Provisions) Act 1993, the Housing Restructuring Act 1992 and the Auckland Airport Act 1987.

met, or if their trust does not satisfy the Arms Length requirements, they must achieve immediate ownership separation, with its consequent losses of value.

The general cross-ownership prohibition in section 17, which prevents owners of lines businesses holding in excess of 10 per cent of a retail business, will have serious ramifications for large electricity trusts, such as Auckland Energy Consumer Trust ("the Trust") - the 100 per cent owner of Mercury Energy. The Trust will be deprived of the ability to participate in the ownership of a valuable part of the business as it currently exists, and this value loss will be borne by the Trust's beneficiaries, the local community.

Persons required to sell their shares in an electricity business as a result of statutorily imposed divestment will, although they receive monetary consideration, no longer own the shares or any profits derived from them. Loss to these persons will also be occasioned by the opportunities forgone to profit on increases in the value of those shares that might have resulted, had the shares been retained and a sale not forced by the Act.

However, these negative results of ownership separation must be balanced against the fact that the government is not directly acquiring or appropriating property, and that many companies have options that do not involve sale.

2 *Third Party Rights Infringements*

The consequences of forced divestment of lines and energy businesses may be very severe for lending institutions and others who enter into obligations with power companies, taking company assets as security. The diminution of assets will directly diminish the amount of security, thereby endangering the recovery by lenders of funds advanced. Separated lines and energy businesses will also face the problem of which of them will accept liability for loans incurred as a vertically integrated entity.

It is equally possible that lenders will consider lending to smaller, divested companies to be too great a risk. It is conceivable, albeit unlikely, that in this situation the government may regulate to force lenders to fund poor risks and accept obligations from weak, separated companies. The danger of this arises from the wide regulation-making powers provided for in section 87(2)(l) of the Act, allowing regulations to be made:

> "Providing for such other matters as are contemplated by or are necessary for giving full effect to this Act and for its due administration"

3 *No Compensation*

A particularly contentious provision, and one that lends weight to the idea that the Act has created a unique form of heavy-handed regulation, is section 69:

> (1) No compensation shall be payable by the Crown to any person or in any other manner howsoever for any loss or damage or any taxation liability arising from the enactment or operation of this Act.
> (2) Subsection (1) applies notwithstanding any other enactments or rule of law.

Private property rights in New Zealand are not protected by the New Zealand Bill of Rights Act 1990, unlike part of the United States Fifth Amendment which provides:

> "...nor shall property be taken for public use, without due compensation."

Section 69 breaches New Zealand's constitutional safeguard for property rights, which lies in Ch 29 of Magna Carta:

> "No freeman shall be ... disseised of his freehold or liberties, or free customs ... but ... by the law of the land."[181]

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[181] Imperial Laws Application Act s 3(1) and First Schedule.

Despite this constitutional tenet, Parliament does have the power to pass legislation that contains a no-compensation clause. In *Cooper v Attorney-General*[182] Baragwanath J considered that:

> "No New Zealand authority supports the proposition that property rights are of such fundamental importance as to prevent Parliament from removing them by legislation which it considers to be in the public interest."

Supporters of the Act believe ownership separation to be justified in the public interest as a means of achieving the objective of enhancing competition to increase consumer welfare. However, it is a clearly established legal policy that private property cannot be alienated, confiscated, or interfered with by the Crown, without compensation. This policy is evident in several New Zealand Acts dealing with compulsory Crown acquisition of private property, such as the Public Works Act 1981.[183] In *Central Control Board (Liquor Traffic) v Cannon Brewery Company Limited*[184] it was found that:

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[182] [1996] 3 NZLR 480, 495.

[183] Public Works Act 1981, s60:

s 60 Basic Entitlement To Compensation-

(1) Where under this Act any land--

(a) Is acquired or taken for any [public] work; or

(b) Suffers any injurious affection resulting from the acquisition or taking of any other land of the owner for any [public] work; or

(c) Suffers any damage from the exercise (whether proper or improper and whether normal or excessive) of--

(i) Any power under this Act; or

(ii) Any power which relates to a public work and is contained in any other Act--

and no other provision is made under this or any other Act for compensation for that acquisition, taking, injurious affection, or damage, the owner of that land shall be entitled to full compensation from the [Crown (acting through the Minister)] or local authority, as the case may be, for such acquisition, taking, injurious affection, or damage.

(2) Where any compensation is payable under subsection (1) of this section to any person who is the lessee under any lease granted by the Crown or the local authority that acquired or took any land that is subject to the lease, that person shall not be entitled to any damages arising from the breach of any express or implied--

(a) Covenant for quiet enjoyment; or

(b) Covenant not to derogate from the grant contained in that lease.

[184] [1919] AC 744,747.

> "There is a presumption that the Legislature does not authorise lands to be taken without a legal right to compensation - a presumption to be rebutted only by clear and unambiguous language."

The Act clearly intends to remove power companies' property by forced divestment, and the lack of compensation for any loss or damage resultant upon this will be contrary to legal policy. Expressly barring compensation is a draconian, unprecedented move by the government that is likely to face challenge. Indeed, the Officials Committee on Energy Policy, which considered possible reform in 1997, concluded that compulsory ownership separation risked litigation claims:[185]

> "There would be a risk of successful litigation against the crown by overseas owners of electricity supply companies who can substantiate a value loss (legislation would be required to eliminate risks in relation to claims by domestic owners)."

VII CONCLUSION

In establishing a framework for ownership separation of electricity lines and supply businesses to eliminate the perceived problems of barriers to access, cross-subsidisation and monopoly profits, the government has unleashed a potentially greater problem: the creation of a unique form of heavy-handed regulation.

The New Zealand Government has recognised that in general, competitive market processes are the most effective solutions to the concerns posed by vertically integrated natural monopolies. Economic efficiency was achieved to a certain extent by the State sector reforms of the 1980s. The corporatisation of government trading enterprises into SOEs established a framework in which contestable and non-contestable functions were separated and the non-contestable areas were made subject to the light-handed prohibitions of the Commerce Act.

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[185] Officials Committee on Energy, Policy Report to Ministers *Electricity Reform: Options for Electricity Distribution and Retailing*, Annex 2, Paper 4 (1 December 1997).

The effectiveness of the Commerce Act has been widely debated, but it is apparent that light-handed controls, including information disclosure, have not effected the level of competition required to provide lower electricity prices to consumers. Nevertheless, the success or failure of light-handed regulation has to be gauged against the probability that natural monopoly is more widespread in New Zealand than in other countries, because of our small market size.[186] It is also important to consider that no form of regulation is able to eliminate all monopoly distortions in the economy.[187]

The Electricity Industry Reform Act 1998 will, by 1 January 2004, dismantle the existing structure of the industry, and substitute a structural framework comprised of separately-owned lines and supply businesses, whose activities will be monitored by the Commerce Commission. ECNZ will be split into four competing State-owned generators, and it is probable that all four will be privatised to maintain the government's distance from commercial decision-making.

The Electricity Industry Reform Act 1998 adheres to the existing policy of separation of contestable from non-contestable elements of business, and general reliance on the provisions of the Commerce Act (augmented by an increased ability for the government to impose price control). For this reason it is not "an example of heavy-handed State intervention of a kind not seen since the days of Muldoonism".[188] However, the Act is heavy-handed in that it interferes markedly with private property rights. The forced divestment of power company assets, without any compensation for loss incurred as part of this divestment, is an unparalleled government action. It does not fit the existing mould of economic or competition regulation. It is a step that should be strongly opposed in any further reforms to New Zealand's industries.

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[186] "Utility Regulation in New Zealand", above n 14, 125.
[187] "Utility Regulation in New Zealand", above n 14, 125.
[188] Doug Matheson, above n 1.

VII GLOSSARY

Capacity The load for which a generating unit, generating station, or other electrical apparatus is rated either by the user or by the manufacturer. Sometimes, the term "capacity" is used as a synonym for "capability"'

Cross-subsidies Measures of the variation between the cost of the service provided and the amount paid by a customer. The difference is funded by payments from other customers.

Distribution The act or process of distributing electric energy from convenient points on the transmission or bulk power system to consumers.

Also a functional classification relating to that portion of utility plant used for the purpose of delivering electric energy from convenient points on the transmission system to consumers or to expenses relating to the operation and maintenance of distribution plant.

Franchise customers Electricity customers who do not have a choice of retailer . Their geographic location determines which retailer sells electricity to them.

Generating station A plant containing prime movers, electric generators, and auxiliary equipment for converting mechanical, chemical, and/or nuclear energy into electric energy.

Hydro-electric An electric generating station in which the prime mover is a water wheel or turbine. The water wheel is driven by falling water.

	Steam (conventional) An electric generating station in which the prime mover is a steam turbine. The steam is generated in a boiler by heat from burning fossil fuels.
Generation, electric	The act or process of transforming other forms of energy into electric energy, to the amount of electric energy so produced.
Gigawatt (GW)	One gigawatt equals 1 billion watts, 1 million kilowatts or 1 thousand megawatts.
Gigawatthour (GWh)	One gigawatthour equals one billion watthours.
Grid	The high voltage transmission network.
Hedging contract	Contracts between generators and wholesale buyers relating to the future supply and consumption of electricity.
Lines Business	The natural monopoly distribution businesses that carry electricity in their wires from the generators to the end-use customers.
Network	A system of transmission or distribution lines so cross-connected and operated as to permit multiple power supply to any principal point on it.
Retail Supply Business	The business of purchasing electricity at bulk supply points and selling it to retail customers. The electricity may be physically transported over a distribution system owned by another party, and payments made for the use of that system.

Ring-fencing The separation of business functions for regulatory purposes. For example, there must be a clear accounting separation of distribution and retail functions within a distribution business.

RPI-X A regulatory formula under which the price of the regulated service is allowed to rise by the level of general inflation, the Retail Price Index (RPI), minus an incentive factor, X, which the regulated company must recover by increasing its efficiency or lowering its costs.

Spot market Market in which electricity is traded, establishing a price for electricity which equates supply and demand for each half-hour of the day.

Substation An assemblage of equipment for the purposes of switching and/or regulating the voltage of electricity. Service equipment, lines transformer installations, or minor distribution and transmission equipment are not classified as substations.

Transmission The act or process of transporting electric energy in bulk from a source of supply to other principal parts of the system or to other utility systems.

Also a functional classification relating to that portion of utility plant used for the purpose of transmitting electric energy in bulk to other principal parts of the system or to other utility systems, or to expenses relating to the operation and maintenance of transmission plant.

Watt The electrical unit of real power or rate of doing work. The rate of energy transfer equivalent to one ampere flowing under an

electrical pressure of one volt at unity power factor. One watt is equal to one joule per second.

IX APPENDIX I

Chronology of the Electricity Industry 1886-1980.[188]

1886 Reefton Electrical transmission of Power and Lighting Co Ltd was registered , and by 1888, plant had been erected and reticulation completed to business premises and private residences in Reefton. The initial installation consisted of a 20 KW Crompton Dynamo, belt driven from a water turbine, installed on the Inangahua River.

The Station was destroyed by a fire in 1911, but the plant was replaced and continued to supply Reefton until 1946, when the company's assets were purchased by the Grey Electric Power Board.[189]

1896 The Electric Motive Power Act authorised reports to be obtained on the possibility of supplying power to the goldfields from the water resources of the colony.[190] This Act prevented the untrammelled private use of all sources of water power for electric generation purposes, with the exception of cases where rights had already been granted to private undertakings.[191]

1903 The Water Power Act vested in the Crown the sole right to use water for generating electricity. The Government reserved to itself control of all sources of power not already granted, with the Governor having the power to acquire as public works, the undertakings of those concerned using rights already granted. Companies were permitted to generate electricity for their own use but not for sale to the public. The Act specifically prevented private generation for general sale and limited the role of private operators

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[188] Ministry of Commerce *Chronology of New Zealand Electricity Reform* (Ministry of Commerce, Wellington, 1998).
[189] Norman McLeod Speer *The Electricity Supply Industry in New Zealand* (Electricity supply Authorities Association of New Zealand, Wellington, 1962), 159.
[190] Speer, above n 189.
[191] Kenneth E Jackson "Government and Enterprise: Early Days of Electricity Generation and Supply in New Zealand" (1988) 1 *British Review of New Zealand Studies*, 105.

in the supply of publicly generated power.

The agency initially charged with developing the considerable hydraulic potential was the Department of Immigration and Public Works, created by Sir Julius Vogel, who was responsible for the emergence of a strong role for the State in developing New Zealand.

1908 The Public Works Amendment Act eased the restrictive approach of the Water Power Act 1903 in principle, but left the State as the dominant force in generation.

1913 The first major hydro station (Horahora, 6.3 MW) was built on the Waikato River by Waihi Gold Mining Company. Horahora was purchased by the Government in 1919 and increased to 10.3 KW capacity in 1925. This was the first step in the Government's national power system in the North Island. The plant continued to operate until 1947, when it was submerged in the lake formed for the Karapiro power Station.

1915 The Government entered the generation market in the South Island with Coleridge Power Station (4.5 MW).

1917 The State Supply of Electricity Act essentially vested all powers in the Minister to control generation, sale and supply of electrical energy by the State.

1918 The Electric Power Boards Act established statutory authorities for the purpose of electricity generation and supply. These were particularly suitable for rural areas and complemented the electricity undertakings established by many of the city and borough councils.

The Act separated distribution functions from generation and transmission, and retailing was thereafter undertaken by a number of Electricity Supply

Authorities - either regional power boards or electricity departments created by local governments.

1925 The Electric Power Boards Act. Electric power boards covered approximately 60% of the area of New Zealand, and about half the population. The remainder of the population lived in the main municipal centres, where electricity was under municipal control.

1928 Section 306 of the Public Works Act vested the power to use water in the Crown, subject to any right lawfully held. Section 254 gave the Crown the power to take land by proclamation.

1945 The Electricity Act established a State Hydro-electric Department responsible for planning, design and the operation of generation and transmission. Thereafter the Ministry of Works conducted the civil construction of power schemes, and the Hydro-electric Department installed electrical plant.

1947 The civil engineering section of the Hydro-electric Department handling design and construction was transferred back to the Ministry of Works, which established a separate power division in 1959.

1945 -1949 Shortages of energy and power capacity, power shortages were very common. Strong popular support for hydro construction emerged.

1950s A Dual Committee System developed:

(1) Committee to Review the Power Requirements ("CRPR") - was involved in demand forecasting, and brought the Department of statistics and the Treasury together with electricity industry representatives; and

(2) New Zealand Electricity Department ("NZED") and the local retail

suppliers group, ESAA (Electrical Supply Authorities Association) worked together to produce 15 year forecasts of demand, which were updated annually.

1958 Meremere coal-fired power station was commissioned.

1960s A cable under the Cook Strait was laid to allow interchange between the systems in the North and South Islands, supposedly minimising the need for thermal firming, because high winter rainfalls in the North Island would balance the low winter inflows in the snow-fed South Island dams. The flow would in theory be in the opposite direction in summer, with the annual thaw flowing into lakes that provided little more than enough storage to regulate annual inflows.

1967 The Water and Soil Conservation Act imposed a regulatory approach to water resources development, including the use of water resources by the Crown for hydro-electric and other purposes. All users of water were then required to make application to registered water boards for water rights, but with Crown applications decided by the National Water and Soil Conservation Authority, after considering the recommendations of the regional water board involved.

1973 The Oil Crisis signalled the need for a coordinated approach to energy policy. The NZED was incorporated into the Ministry of Energy, and the Ministry undertook a strategic planning process.

Feb 1980 The Government released an international marketing document: "Growth Opportunities in New Zealand", and invited proposals for electricity-intensive industries to take up a surplus generating capacity estimated at 5000 GWh. Much of the surplus was from oil-fired thermal plant, or combustion turbine plant, and oil fuels escalated rapidly in price after the 1979 Iranian Revolution.

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