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MEMORANDUM OF UNDERSTANDING

BETWEEN

THE GOVERNMENT OF NEW ZEALAND

AND

ELECTRICITY CORPORATION OF NEW ZEALAND

MEMORANDUM OF UNDERSTANDING

entered into on 8 June 1995 by

THE GOVERNMENT OF NEW ZEALAND

and

ELECTRICITY CORPORATION OF NEW ZEALAND**Background**

A. The way in which electricity is produced and consumed over time has a material impact on the economy and the environment.

B. The Government's overall energy policy objective is to ensure the continuing availability of energy services at least cost to the economy as a whole, consistent with sustainable development.

C. To achieve this overall objective in the wholesale electricity sector, the Government considers that the following outcomes are necessary—

- pricing of electricity in a manner that signals the full cost of producing each extra unit of electricity, so that investors and consumers can make decisions which seek to get the most value from each extra unit of electricity purchased; and
- strong pressure on electricity costs and prices, especially in the areas of new investment, over the next 10 years and beyond so that electricity producers are forced to find innovative, least-cost solutions.

D. After careful consideration of a range of options, the Government has concluded that these outcomes are likely to be best achieved by a process of sustained and robust rivalry, and in particular by—

- vigorous competition among electricity producers, including new private sector generators; and
- contestability from energy efficiency options as an alternative to buying more power; and
- providing buyers with a diversity of prices and other conditions for purchasing electricity on contract; and
- competitive disciplines on prices for electricity in the spot market.

E. The principal barriers to sustained and robust rivalry are—

- the high level of dominance in the spot, contracts, and new investments markets by ECNZ, which presently generates approximately 96% of all electricity produced in New Zealand; and
- uncertainty as to the role that governments will play over the next ten years and beyond in relation to ECNZ's pricing and new investment decisions; and
- the absence of effective market mechanisms which buyers and sellers of electricity can use to forecast future prices.

F. The Government and ECNZ have agreed that—

- subject to appropriate consultation by the Government with Maori as to any Treaty of Waitangi issues, the measures set out in this Memorandum should be implemented; and
- implementation of these measures will be a significant step in overcoming the barriers referred to above.

G. It is important for New Zealand's economy and environment that these barriers are overcome in a manner and at a rate that—

- recognises the particular characteristics of the New Zealand electricity system; and

- maintains security of supply; and

- enables producers, distributors, retailers, and consumers to develop the systems, skills, and experience necessary to operate effectively in a competitive environment.

H. A market with stronger competitive disciplines will emerge over time. During the transitional period—

- a set of special regulatory restraints, which are set out in this Memorandum, will apply to ECNZ. ECNZ's commitment to work within the spirit and intent of these restraints will strengthen the effectiveness of the restraints in addressing ECNZ's dominance; and
- industry participants are to be encouraged to rely on commercial mechanisms, rather than seeking Government involvement, in the pricing and contracting of electricity. ECNZ has an important role in ensuring this by operating in a manner which promotes genuinely competitive processes.

I. The Government will—

- closely monitor the results achieved from implementing the measures set out in this Memorandum against the outcomes referred to in paragraphs B and C above; and
- in particular, expect to see a continuing reduction over time in ECNZ's level of dominance in the spot, contracts, and new investments markets.

Further evolutionary steps towards a fully competitive wholesale electricity market may need to be considered by the Government after allowing for an appropriate evaluation of the outcomes achieved from the measures set out in this Memorandum.

J. The Government has ruled out privatisation, and any restructuring that has as its aim the sale of any major component of ECNZ.

K. This Memorandum is not intended to create legal rights for either ECNZ or the Government, and nothing in it limits in any way the rights and responsibilities of the Government.

The explanatory notes in italics in this Memorandum are included only for the purpose of giving the backgrounds and/or explanations of the clauses to which they relate, and are not to be taken as part of this Memorandum.

PART 1**Measures to Achieve Objectives****1.1 New SOE based on the Taranaki thermals, Clutha, and geothermals**

A new State-owned enterprise is to be established as a commercially viable entity and as an effective competitor to ECNZ. The new SOE will acquire from ECNZ, in accordance with the provisions of Appendix 1, the New Plymouth, Stratford, Whirinaki, Otahuhu, Wairakei, Ohaaki, Clyde, and Roxburgh power stations, the Clutha and geothermal development sites, and an appropriate share of ECNZ's rights under the Maui gas contracts.

Explanatory note:

This will—

- establish a significant and effective competitor to ECNZ, starting with about 28% of the market in MW terms and 22% in energy (GWh) terms;
- ensure that the new SOE will hold key development sites for possible new generation, and accordingly be well placed to further reduce ECNZ's share of the market.

1.2 Proposed Taranaki combined cycle/gas sale

ECNZ is to conclude the current sales process in accordance with Appendix 2, subject to resource consents and to the objective of maximising value.

Explanatory note:

This measure will—

- reduce ECNZ's market share by approximately 7% in energy terms and 5% in capacity terms
- introduce another independent competitor to ECNZ, which will provide competitive benchmarks in regard to performance.

1.3 Sale of small hydro-stations

ECNZ is to sell the Cobb, Coleridge, Highbank, Matahina, Mangahao, Tuai, Piripaua, and Kaitawa hydro-stations in accordance with Appendix 3, subject to appropriate consultation with Maori as to any Treaty of Waitangi issues.

Explanatory note:

The sale of these stations will be completed progressively in the ordinary course of ECNZ's business.

In aggregate, these sales will reduce ECNZ's share of the market by approximately 4%.

These sales should provide the opportunity for management of these stations by persons attuned to local conditions (for example, existing power companies), and for the achievement of greater operating efficiencies.

1.4 Cap on ECNZ providing additional generating capacity

ECNZ will be subject to a restriction, set out in Appendix 4, on the amount of additional generating capacity it may provide.

Explanatory note:

The cap will prevent ECNZ from providing additional generating capacity unless non-ECNZ producers have first provided at least an equal amount of additional capacity.

The cap works in tandem with the requirement in paragraph 1.5 for ECNZ to "ring-fence": the cap governs when ECNZ can provide additional capacity, whereas "ring-fencing" governs the basis on which ECNZ may provide any additional capacity when the cap allows it to enter the market.

The cap will assist in ensuring that—

- the output prices of at least 50% of additional generating capacity reflect the true costs, thereby encouraging consumers to extract the greatest value to them from additional electricity consumption;
- ECNZ's market dominance is reduced over time;
- vigorous competitive pressure on costs and prices, and a diversity of views on the technology, size, location, and timing of new generating capacity, emerges;
- the Government's fiscal risk is reduced.

1.5 Ring-fencing of additional generating capacity provided by ECNZ

Additional generating capacity provided by ECNZ will be "ring-fenced" in accordance with Appendix 5.

Explanatory note:

Ring-fencing will—

- restrict ECNZ's ability to cross-subsidise any additional capacity and help ensure that the electricity produced from additional capacity is priced to reflect the full cost of producing it; and accordingly
- facilitate competitive entry into the electricity market

by other generators and suppliers of demand-side management options.

1.6 Spot market dominance

ECNZ will put in place a contract offer mechanism in accordance with Appendix 6.

Explanatory note:

This will—

- provide market participants with a reasonable opportunity to insure against incentives ECNZ may have over time to unduly influence the spot market; and
- give greater stability to the new market, by reducing the extent of participants' exposure to volatile spot prices; and
- provide greater certainty as to how the market will operate, and help address concerns in relation to spot pricing by ECNZ.

1.7 Revisions to ECNZ's statement of corporate intent

ECNZ's statement of corporate intent will be amended in accordance with Appendix 7.

Explanatory note:

These amendments reflect the fact that a significant competitor is to be established, and that the measures set out in this Memorandum will facilitate the introduction of competitive processes for the pricing and contracting of electricity.

1.8 Removal of retail constraints on ECNZ

ECNZ is currently prohibited by a shareholders' directive under section 13 of the State Owned Enterprises Act 1986 which is included in its statement of corporate intent, from acquiring any electricity supply authority or any significant share in an electricity supply authority (now called an energy company). This restraint will cease to apply when ECNZ's share (including its interest in joint ventures referred to in Appendix 4 and in companies ring-fenced under Appendix 5) of the total generating capacity measured in MW capacity terms is less than 45%, but ECNZ will remain subject to the remaining provisions of its statement of corporate intent and the then prevailing regulatory regime.

Explanatory note:

It is appropriate to maintain the current prohibition on ECNZ until its market share is further significantly reduced.

As a general policy, the Government is concerned to ensure that natural monopoly line businesses do not abuse their position and, in particular, do not cross-subsidise competitive activities such as generation and energy retailing.

PART 2

Miscellaneous

2.1 Key tasks for implementation

The key tasks for implementing the measures set out in Part 1 are as follows:

- appropriate consultation by the Government with Maori as to any Treaty of Waitangi issues;
- appointment of the SOE Development Group, negotiation of the sale and purchase agreement, and negotiation of the funding agreement;
- establishment of the new SOE, including the organisational separation from ECNZ;
- implementation of the cap on additional generating

capacity of ECNZ, and the ring-fencing of any such additional capacity;

- implementation of the contract offer mechanism referred to in paragraph 1.6;
- the Taranaki combined cycle/gas sale;
- the sale of the small hydro-stations.

In parallel with the above, pool rules will need to be developed by the industry within the Government's public policy objectives.

2.2 Timetable and responsibilities

A timetable setting out various tasks for implementing the measures set out in Part 1, and the allocation of responsibility and the target completion date for each task, is set out in Appendix 8.

2.3 Matters relating to implementation

Each Appendix is to be implemented in the manner which best gives effect to the objective set out at the beginning of the Appendix.

Until the new SOE has been established, references to the new SOE are to be regarded as references to the SOE Development Group.

2.4 Intention to abide by this Memorandum

The Government and ECNZ intend to—

- abide by this Memorandum in accordance with its purpose, spirit, and intent; and
- take any steps reasonably necessary to give effect to this Memorandum.

2.5 Alteration of Memorandum

This Memorandum may be added to or amended by a supplemental document signed on behalf of the Government and ECNZ.

2.6 Memorandum not to create legal rights

This Memorandum is not intended to create legal rights.

SIGNED on behalf of the Government of New Zealand by **William Francis Birch**, Minister of Finance, and **Douglas Lorimer Kidd**, Minister of Energy, and **Philip Ralph Burdon**, Minister for State-Owned Enterprises, and **Simon David Upton**, Minister for the Environment.

SIGNED on behalf of Electricity Corporation of New Zealand Limited and its subsidiaries ("ECNZ") by **Selwyn John Cushing**, Chairman and **Victor Wu**, Director.

APPENDIX 1

Establishment of New SOE

Objective

1. The new State-owned enterprise referred to in clause 1.1 is to be established in accordance with this Appendix—

- as a commercially viable entity; and
- as an effective competitor to ECNZ.

Power stations and other assets to be sold to new SOE

2. ECNZ will sell to the new SOE:

- the New Plymouth, Stratford, Whirinaki, Otahuhu, Wairakei, Ohaaki, Clyde and Roxburgh power stations; and
- all related assets, rights (including resource consents), and development sites owned by ECNZ, and especially—
 - all of the upper and lower Clutha development sites; and
 - all geothermal development sites; and

– the Tariki/Ahuroa/Waihapa/Ngaere gas contract.

Maui Gas

3. ECNZ and the SOE Development Group will, as part of the asset transfer process, negotiate contractual arrangements for the use of Maui gas in accordance with the following framework:

- ECNZ will transfer to the new SOE all of its rights and obligations under the contractual arrangements between ECNZ and the Crown relating to Maui gas (for convenience referred to below as "the Maui contract").
- ECNZ will complete its negotiations for the sale of gas from the Maui contract under the process for selling the Taranaki combined cycle (TCC) gas referred to in Appendix 2. If that sales process has not been concluded before the formation of the SOE Development Group, the new SOE will have full access to all information and work with ECNZ on that sale, but the new SOE will not participate directly in negotiations with prospective buyers. (For convenience, the gas contract or contracts to be formed under that sales process are referred to below as the "TCC gas contract").
- ECNZ will transfer to the new SOE all of its rights and obligations under the TCC gas contract.
- ECNZ will purchase from the new SOE on an annual take or pay basis, at the Maui contract price, any remaining gas available under the Maui contract which is in excess of the quantity required:
 - to run Stratford at its maximum technical capacity (for convenience referred to below as "the Stratford block"); and
 - to run New Plymouth at its maximum technical capacity (less that fuel supplied under the Tariki/Ahuroa/Waihapa/Ngaere contract); and
 - under the TCC gas contract.
- The new SOE and ECNZ will develop fully commercial arrangements for the use of gas from the Stratford block to provide ECNZ with access to the Stratford block, whenever Stratford is not running to cover peak or dry periods, for use at its existing Huntly plant.

4. Once the initial contractual arrangements have been established, it is expected that ECNZ and the new SOE, in conjunction with other suppliers and users of gas, will develop commercial arrangements for trading gas to reflect their short term operating requirements.

5. The Government will use its best endeavours to negotiate an agreement with the Maui joint venture partners to allow ECNZ access to information under the Maui contract (following its transfer to the new SOE) as follows:

- ECNZ to have the right to require that the new SOE exercise its rights to obtain information from the Crown as provided for under the Maui contract; and
- ECNZ to have access to any information which the new SOE obtains under the Maui contract.

Explanatory note:

The Government is seeking an economically efficient allocation of gas between ECNZ and the new SOE based on commercial processes. This requires a framework for negotiation which provides a reasonable balance of strength between the parties; in particular, the price offered by the company selling Maui gas should be disciplined by the availability to the other company of reasonably priced alternative fuels. The new SOE should therefore hold the Maui gas contract because the new

SOE's thermal plants have a more limited choice of fuels. The new SOE and ECNZ will have strong commercial incentives to establish efficient arrangements for trading gas which is not used by the new SOE in normal hydro and non-peak periods.

Transfer of staff

6. It is intended that ECNZ staff associated with the power stations referred to in paragraph 2 above, will be transferred to the new SOE.

If any redundancies or severances occur after the date of transfer of the power station staff, the employer in each case shall bear the costs.

7. ECNZ and the SOE Development Group will agree an appropriate process to allow a proportion of the Clyde Group, Wellington and Marketing staff to transfer to the new SOE. ECNZ and the new SOE will endeavour to avoid redundancies or severances arising from this process. If any such redundancies or severances do occur, the costs will be shared between ECNZ and the new SOE in the proportion of 70% to ECNZ and 30% to the new SOE. The new SOE will pay its share of any such costs to ECNZ after the separation is completed.

Explanatory note:

The approach outlined above is intended to avoid redundancies and severances in the separation process. The agreed cost-sharing arrangement will create strong incentives for ECNZ and the new SOE to put in place a process that ensures a smooth staff transition.

Intellectual property

8. During the period between the date of this Memorandum and the transfer of assets to the new SOE, ECNZ will provide to the new SOE access to all intellectual property required to achieve the objective set out in paragraph 1 above.

9. On transfer of the assets to the new SOE, ECNZ will provide the new SOE with duplicates of all intellectual property required to achieve the objective set out in paragraph 1 above, and the new SOE will pay for any reasonable duplication costs.

10. For the avoidance of doubt, a duplicate copy of the strategic models Spectra and Prism and all intellectual property held by ECNZ relating to the Maui contract will be provided by ECNZ to the new SOE.

Treaty of Waitangi

11. The Government will consult with Maori on matters set out in this Appendix which may give rise to Treaty of Waitangi issues.

Implementation objectives

12. Implementation of this Appendix should be achieved in a manner that meets the objective in paragraph 1 and also the following objectives:

- the implementation should be undertaken in a manner which
 - minimises any adverse impacts on the financial statements of the Government and ECNZ; and
 - is consistent with the State-Owned Enterprises Act 1986 and the duties of the ECNZ directors under that and other legislation.
- ECNZ and the new SOE should be fully independent as soon as possible;
- the costs of implementation should be minimised.

Implementation process

13. Implementation of this Appendix will be carried out by the ECNZ Board and the SOE Development Group, in

consultation with the Government to allow monitoring of outcomes against public policy objectives.

14. The SOE Development Group will be required to certify to the shareholding Ministers whether, in the Group's opinion, the objective set out in paragraph 1, and other objectives determined by the Government, are likely to be achieved; and the Government will have regard to this certificate in making decisions on the establishment of the new SOE.

Financial parameters

Valuation and financial structure

15. Issues relating to the valuation of assets, and any liabilities, to be transferred from ECNZ to the new SOE are to be agreed by ECNZ, the SOE Development Group and the shareholding Ministers.

16. The financial structures of ECNZ, and of the new SOE, are to be agreed by ECNZ and the SOE Development Group respectively with their shareholding Ministers.

17. To facilitate the separation process the objective of both the Government and ECNZ is to transfer assets to the new SOE at book value. This approach will be followed provided that the shareholding Ministers are satisfied that it is consistent with the overall objective set out in paragraph 1 of this Appendix.

18. ECNZ and the new SOE will undertake to review their asset valuations and capital structures within 12 months of the separation date (or such other date as agreed between each company and its shareholding Ministers).

19. The purpose of such reviews is to provide an opportunity to adjust the financial structure of either or both companies to reflect the establishment of long term contracts, and to ensure both companies have asset values suitable for their future operation.

Transfer of individual assets or of a subsidiary company

20. The issue of whether the separation will be achieved by the transfer of assets or shares in a subsidiary company will be negotiated between ECNZ and the SOE Development Group, with the final plan requiring the approval of shareholding Ministers.

Procedure for ECNZ to repay equity capital to the Crown

21. Following the transfer of assets to the new SOE, ECNZ will have surplus equity capital.

22. Subject to the approval of shareholding Ministers, ECNZ will re-register under the Companies Act 1993 prior to separation. This would enable ECNZ to pay the Crown, as provided by that Act, the surplus shareholders funds arising from the transfer of assets to the new SOE.

23. If re-registration does not proceed prior to separation, the alternative course will be for ECNZ to seek High Court approval under the Companies Act 1955 for a capital reduction.

Details of financial flows

24. The timing and amounts of financial flows will be determined by shareholding Ministers on the advice of ECNZ and the SOE Development Group. Provided the shareholding Ministers are satisfied that the proposed flows are consistent with the objectives set out in paragraph 1 above, the expected set of transactions to occur on settlement date is as follows:

- (a) the Crown supplies appropriate capital to the new SOE on the basis of a proposal from the SOE Development Group;
- (b) the new SOE uses these funds for working capital

and to purchase a portfolio of assets and liabilities, or shares in a subsidiary company, from ECNZ for cash;

(c) ECNZ sells a portfolio of assets and liabilities, or shares in a subsidiary company, for cash to the new SOE, and uses all of the proceeds to reduce its capital and, if appropriate, make a loan to the Crown. The amount and terms of any loan of any debt finance the Crown supplies to the new SOE under paragraph (a) above would be identical to the amount and terms of the loan from ECNZ to the Crown;

(d) ECNZ may use a portion of any loan to the Crown as security for an in-substance debt defeasance transaction. Such a defeasance should enable ECNZ to reduce the size of its balance sheet without adversely affecting the rights of its creditors.

Target dates

25. The target date for completion of the matters referred to in paragraphs 2, 3, and 5 to 10 above is 31 January 1996.

Dispute resolution

26. If agreement cannot be reached for the purposes of paragraph 15 or 16 above by a date set by the shareholding Ministers, the matters not agreed will be determined by the shareholding Ministers.

27. If a difference arises between the ECNZ Board and the SOE Development Group which prevents agreement being reached between them on a matter referred to in this Appendix, they are encouraged to seek external mediation, but if the difference cannot be resolved by a date—

- to be agreed by ECNZ and the SOE Development Group; or
- to be set by the shareholding Ministers (where ECNZ and the SOE Development Group have failed to agree on a date by a time specified by the shareholding Ministers)—

then, unless the shareholding Ministers otherwise determine, ECNZ and the SOE Development Group will be bound by the decision of an independent expert. The independent expert will be appointed by agreement between ECNZ and the SOE Development Group, or, if agreement is not reached within 14 days of the date referred to above, by the shareholding Ministers.

APPENDIX 2

Proposed Taranaki Combined Cycle Gas Sale

Objective

1. ECNZ is to conclude the current sales process in accordance with this Appendix, subject to resource consents and to the objective of maximising value.

Target completion date

2. The date agreed between the ECNZ Board and the shareholding Ministers.

Linkage between gas and site

3. ECNZ has not precluded bids for the gas only, or for use of the gas (delivered from any or all of the three ECNZ delivery points on the Maui pipeline) at sites other than at Stratford and/or at more than one site.

Explanatory note:

It is important that bidders for the project have flexibility as to the location and size of plant. This will help ensure that the best use is made of the relevant gas from the perspective of the economy as a whole.

Rebalancing no longer applies

4. A condition of ECNZ's initial invitation to bid was that bids would be evaluated in the context of an overall

average increase in North Island energy prices of 0.4c/kWh. The measures agreed in this Memorandum mean that this condition no longer applies.

Explanatory note:

The condition in ECNZ's invitation to bid was predicated on ECNZ continuing to hold its current capacity. The measures agreed in this Memorandum mean that this assumption is no longer valid.

APPENDIX 3

Sale of Small Hydro-Stations

Objective

1. The Cobb, Coleridge, Highbank, Matahina, Mangahao, Tuai, Piripaua, and Kaitawa hydro-stations are to be sold by ECNZ in accordance with this Appendix, subject to appropriate consultations with Maori as to any Treaty of Waitangi issues.

Consultation with Maori

2. The Government will consult with Maori as appropriate on any Treaty of Waitangi issues arising in regard to the sales.

Potential buyers

3. Each hydro-station referred to above will be available for purchase on a proper commercial basis by —

- energy companies (formerly called electricity supply authorities) or Maori interests within the general region of the station (where the size of the region, to be determined by ECNZ in consultation with shareholding Ministers, is sufficient to provide a reasonable degree of contestability for the station); or
- any company or other person that is effectively controlled by any such energy company and/or Maori interests.

Target completion date

4. 18 months after the date of transfer to the new SOE of effective control of the power stations referred to in Appendix I (or any later date agreed by the Government and ECNZ for the sale of a particular small hydro station, to be considered where there is a strong possibility of ECNZ completing a sale of that station within a reasonable period after that date of transfer).

Fallback if stations not sold by target date

5. If any hydro-station is not sold by the target date, ECNZ will offer to sell it to the new SOE at its book value at the date of this Memorandum.

APPENDIX 4

Cap on ECNZ Providing Additional Generating Capacity

Objective

1. For the period that ECNZ's share of the total New Zealand generating capacity (measured in MW) is more than 45% of that total, at least 50 percent of additional generating capacity in New Zealand is to be built by parties fully independent of ECNZ. This mechanism (the "cap") is intended to ensure—

- that the output prices of at least 50 percent of additional capacity reflect true costs; and
- that ECNZ's market dominance is reduced over time; and
- the emergence of vigorous competitive pressure on costs and prices, and a diversity of views on the technology, size, location and timing of new stations; and

- lower fiscal risk to the Crown.

Explanatory Note:

ECNZ can provide additional generating capacity in New Zealand only if non-ECNZ parties have first built at least an equal amount of additional capacity in New Zealand.

Definitions

2. Additional generating capacity is "provided" by ECNZ where—

- the development of the additional capacity is effectively controlled by ECNZ; and/or
- the sale of all or any part of the electricity produced from the additional capacity to any wholesale buyer (other than ECNZ) is effectively controlled by ECNZ.

3. In this Appendix, a "non-ECNZ party" is a person which is fully independent of ECNZ and in which ECNZ has no direct or indirect financial or other interest (but—

- a business arrangement in which ECNZ participates with another person only in regard to an overseas project, or a New Zealand project involving only energy efficiency, co-generation and/or generation from non-traditional renewable sources; or
- the provision by ECNZ to a person of financial, design, or operating and maintenance services—

does not constitute an interest by ECNZ in that person).

Rules

Entitlement System

4. A system of MW credits ("credits") and MW debits ("debits") will be established to determine ECNZ's entitlement to provide additional generating capacity. ECNZ's entitlement will be the sum of the credits and debits. This entitlement will not create any legal rights. The table in Annex A illustrates the system.

5. Two key features of the system are as follows:

- In broad terms, each MW of additional capacity built by a non-ECNZ party (excluding the proposed Taranaki combined cycle station and any additional capacity using part or all of the gas associated with that proposal) will create a credit, and each additional MW of capacity provided by ECNZ will incur a debit.
- ECNZ may provide additional capacity only if it has a positive entitlement which is equal to or greater than the debits it would incur from the additional capacity.

6. The effective start date for the counting of credits towards and debits against ECNZ's entitlement will be the date of this Memorandum.

7. For administrative convenience, additional generating capacity under 1 MW will not be taken into account.

Non-ECNZ Building

8. Additional generating capacity built by a non-ECNZ party will (except as set out below) create a credit when the non-ECNZ party enters into binding contracts for the purchase of major plant or major capital works.

ECNZ Building

9. ECNZ's entitlement will be debited when tenders are called for the purchase of major plant or major capital works for additional generating capacity to be provided by ECNZ. If a tender process is abandoned by ECNZ, the debit will be reversed.

10. ECNZ will not require an entitlement before purchasing land, applying for resource consents, or undertaking evaluation, feasibility studies, or design work.

Joint Ventures

11. Where ECNZ has effective control: If ECNZ has effective control of a joint venture that provides additional generating capacity—

- the full MW capacity of the joint venture project will be debited against ECNZ's entitlement; and
- the share of the joint venture held by non-ECNZ parties will not be credited towards ECNZ's entitlement.

12. Where ECNZ does not have effective control: If ECNZ does not have effective control of a joint venture that provides additional generating capacity—

- a proportion of the full MW capacity of the joint venture project, corresponding to ECNZ's share of the joint venture, will be debited against its entitlement; and
- the share of the joint venture held by non-ECNZ parties will not be credited towards ECNZ's entitlement.

13. In this Appendix, a "joint venture" includes any business arrangement in which ECNZ participates with any other person in respect of the provision of any additional generating capacity.

Project Abandonment

14. If any additional ECNZ generating capacity is abandoned (including mothballing) after a debit is incurred, the debit will be reversed. ECNZ's entitlement will be debited on any subsequent recommissioning of the capacity.

15. If any additional non-ECNZ generating capacity is abandoned (including mothballing) after a credit is established, the credit will be reversed. However, if this means that ECNZ no longer has sufficient entitlement to provide additional generating capacity that it is already committed to—

- ECNZ may continue with the provision of that capacity; but
- ECNZ may not provide further additional generating capacity until it has accumulated sufficient credits to offset both the resulting negative entitlement and the debits that will be incurred from the additional capacity.

Transfers of power stations from ECNZ

16. Meremere and Marsden A and B: A transfer of Meremere and/or Marsden B thermal stations will not create credits. A transfer of Marsden A station as a going concern will create 60 MW credits.

17. Small hydro-stations: A transfer as a going concern of any or all of the Cobb, Coleridge, Highbank, Matahina, Mangahao, Kaitawa, Tuai and Piripaua hydro stations will not create credits.

18. Transfer of proposed TCC station: A transfer of the proposed Taranaki combined cycle station (or any transfer of any plant using part or all of ECNZ's gas which has been associated with this proposed station) will not create credits.

19. Other ECNZ stations: A transfer as a going concern of—

- all or any part of the other existing ECNZ stations that will not be transferred to the new SOE; or
- any additional generating capacity provided after the date of this Memorandum (excluding the proposed Taranaki combined cycle station and any additional capacity using part or all of the gas associated with that proposal) —

will create credits equal to double the MW capacity which is transferred, in recognition of the fact that any sale will both increase non-ECNZ generation and decrease ECNZ generation.

Explanatory note:

Paragraph 19 has been included for the sake of completeness, as the rules set out in this Appendix are intended to apply for so long as ECNZ's share of the total New Zealand generating capacity is more than 45%.

As stated above, the Government has ruled out privatisation, and any restructuring that has as its aim the sale of any major component of ECNZ.

20. For the avoidance of doubt the transfer of ECNZ power stations to the new SOE pursuant to this Memorandum will not create credits.

21. In this Appendix, 'transfer' means a completed transfer to a non-ECNZ party of effective control.

Acquisitions by ECNZ

22. The acquisition of effective control of any existing generating capacity, or any additional generating capacity for which credits have been created, by ECNZ from a non-ECNZ party will reduce ECNZ's entitlement by double the MW capacity of the capacity acquired.

Decommissioning of stations

23. Meremere and Marsden A and B: ECNZ will receive no credits on decommissioning Meremere and/or Marsden B. ECNZ will receive 60 MW credits on decommissioning Marsden A.

24. Small hydro stations: ECNZ will receive no credits on decommissioning any or all of the Cobb, Coleridge, Highbank, Matahina, Mangahao, Tuai, Piripaua, and Kaitawa hydro stations.

25. Other ECNZ stations: On decommissioning the whole or part of any ECNZ station other than those referred to in paragraphs 23 and 24, ECNZ will receive credits equal to the reduction in the MW capacity of the station as a result of the decommissioning.

Refurbishments and modifications

26. Meremere and Marsden A and B: Any refurbishment or modification to any of the Meremere, Marsden A or Marsden B thermal stations which increases its capacity above its 'deemed capacity' will be debited against ECNZ's entitlement for the amount of the increase above the deemed capacity. For the purposes of this paragraph, Meremere and Marsden B (which are currently mothballed) will be deemed to have a capacity of zero MW, and Marsden A will be deemed to have a capacity of 60 MW.

27. Huntly: Any increase in Huntly's capacity to above 1000 MW (other than an increase to 1075 MW in an emergency situation) will be debited against ECNZ's entitlement.

28. All ECNZ hydro stations: Any increase in the capacity of any ECNZ hydro station will be debited against ECNZ's entitlement, except that any refurbishment or modification of an ECNZ hydro station which extracts more electrical energy from the amount of water which is available from the station's current catchment configuration will not be debited against ECNZ's entitlement. For the avoidance of doubt -

- this exception is intended to permit more electrical energy to be extracted from the current 'head' and intake water volumes for each station, without debiting ECNZ's entitlement; but

- ECNZ's entitlement would be debited for increases in MW capacity which result from the installation of any systems to increase the amount of water which feeds into, or is retained by, a catchment area.

Co-generation and generation from non-traditional renewable sources

29. Any additional capacity using co-generation or non-traditional renewable sources—

- if provided by a non-ECNZ party, will not create credits;
- if provided by ECNZ, will not incur debits.

In this Appendix,—

"Co-generation" means generating plant where a significant proportion of the heat input is a by-product of another process, or where a significant proportion of the generation waste heat is used as a source of heat for another process; and, in any case, the electricity generated must be used principally on-site.

"Non-traditional renewable sources" mean renewable energy sources other than hydro and geothermal.

Implementation

30. The cap will be included in ECNZ's Statement of Corporate Intent by direction of the shareholding Ministers under section 13 of the State-Owned Enterprises Act 1986.

31. The cap will be administered by the Secretary of Commerce. In particular, the Secretary will make final decisions on credits and debits. In deciding on the application of the rules for determining ECNZ's entitlement, the Secretary will have regard to the objective set out in paragraph 1 above.

32. ECNZ's entitlement must be verified by the Secretary of Commerce before ECNZ commits itself to provide additional generating capacity.

Duration

33. The cap will cease to apply when ECNZ's share (including its interests in joint ventures and in companies ring-fenced under Appendix 5) of the total New Zealand generating capacity measured in MW capacity terms is less than 45% of that total, and that share has been verified by the Secretary of Commerce.

ANNEX A

Illustration of Entitlement System

	A ₁	B	C ₁	D
Period (t)	ECNZ entitlement carried forward (MW)	Non-ECNZ provided generation (MW) (Credits)	ECNZ entitlement (MW)	ECNZ provided generation (MW) (Debits)
1	0	80	80	0
2	80	200	280	150
3	130	50	180	0
4	180	320	500	500

Net change in generating capacity:

ECNZ (including any unused entitlement carried forward at the end of the period covered by the table) 650 MW

Non-ECNZ 650 MW

¹ A_{t+1} = C_t - D_t, C_t = A_t + B_t; where t = 1, ..., ∞.

APPENDIX 5***Ring-Fencing of Additional Generating Capacity Provided by ECNZ*****Objective**

1. Additional generating capacity provided by ECNZ in New Zealand will be "ring-fenced" in order to—

- restrict ECNZ's ability to cross-subsidise the additional capacity and thereby ensure that the electricity produced from the additional capacity is priced to reflect the full cost of producing it; and accordingly
- facilitate competitive entry into the electricity market by other generators and demand-side management suppliers.

General Rule

2. Ring-fencing will be required for any additional generating capacity provided by ECNZ in New Zealand where the capacity is more than 10 MWs and—

- ECNZ would have effective control over the development of the capacity; or
- ECNZ would have effective control over the sale to any wholesale buyer (other than ECNZ) of all or any part of the electricity produced from the capacity.

3. However, any refurbishment or modification of an existing generating station which does not require ECNZ's entitlement to be debited under the cap regime in Appendix 4 will not have to be ring-fenced.

Key elements

4. Ring-fencing of additional generating capacity will require—

- the formation of a separate company to provide the additional capacity, which must be operating before tenders are called for the purchase of major plant or major capital works; and
- ECNZ to charge the separate company on the basis of full costs for any capital, goods (except gas), and services it provides to the company, and on the basis of full opportunity costs for gas; and
- where the electricity produced by the separate company is sold on contract, the contract is to be completely separate from any contract for electricity produced by ECNZ or any person associated with ECNZ; and
- the achievement of a proper commercial return on the assets and shareholders funds in the separate company; and
- the separate company and ECNZ to comply with the financial guidelines established under paragraph 6 below.

5. For the avoidance of doubt, a ring-fenced company would be permitted to raise debt capital backed by guarantees from ECNZ, so long as an appropriate level of equity finance was provided to the company by ECNZ.

Financial Guidelines

6. Guidelines for the financial policies necessary to implement ring-fencing would be specified in advance by ECNZ and would be subject to approval by an independent person appointed by the Secretary of Commerce. The guidelines would cover in particular—

- depreciation rates for assets of the company;
- cost allocation and pricing methodologies for any capital, goods and services provided by ECNZ to the company, and by the company to ECNZ;

- determining a proper commercial rate of return for the company.

Monitoring

7. An independent auditor appointed by the Secretary of Commerce, in consultation with ECNZ, will be required to ascertain, and provide annual public certification (which would appear in ECNZ's annual report) as to, whether ECNZ is complying with these ring-fencing requirements.

Implementation

8. These ring-fencing requirements will be included in ECNZ's Statement of Corporate Intent by direction of the Shareholding Ministers under section 13 of the State-Owned Enterprises Act 1986.

9. The Secretary of Commerce will make the final decision on whether additional generating capacity is required by paragraph 2 above to be ring-fenced, having regard to the objective in paragraph 1 above.

Duration

10. These ring-fencing requirements will cease to apply when ECNZ's share (including its interests in ring-fenced companies and in joint ventures as defined in Appendix 4) of the total New Zealand generating capacity measured in MW capacity terms is less than 45% of that total, and that share has been verified by the Secretary of Commerce.

APPENDIX 6***Contract Offer Mechanism*****Objective**

1. A commercial mechanism is to be established to—

- provide market participants with a reasonable opportunity to limit possible incentives ECNZ may have over time to unduly influence the spot market;
- give greater stability to the new market (by reducing the extent of customers' exposure to volatile spot prices); and
- provide greater certainty as to how the market will operate, and help address concerns in relation to spot pricing by ECNZ.

Mechanism

2. ECNZ will offer, on at least an annual basis, sufficient contracts to ensure that customers have the opportunity to contract ECNZ up to at least the levels specified in the following table:

Years ahead	Percentage of firm capacity
1	87%
2	70%
3	50%
4	40%
5	30%

These figures include the amount contracted to the NZ Aluminium Smelters plant at Tiwai Point.

3. These contracts will be at prices which are not directly related to the short term (within the year) movement of spot prices.

4. In this Appendix, 'firm capacity' is that capacity which ECNZ could provide for sale, assuming 87% availability at Huntly power station and 80% of mean production from all hydro capacity.

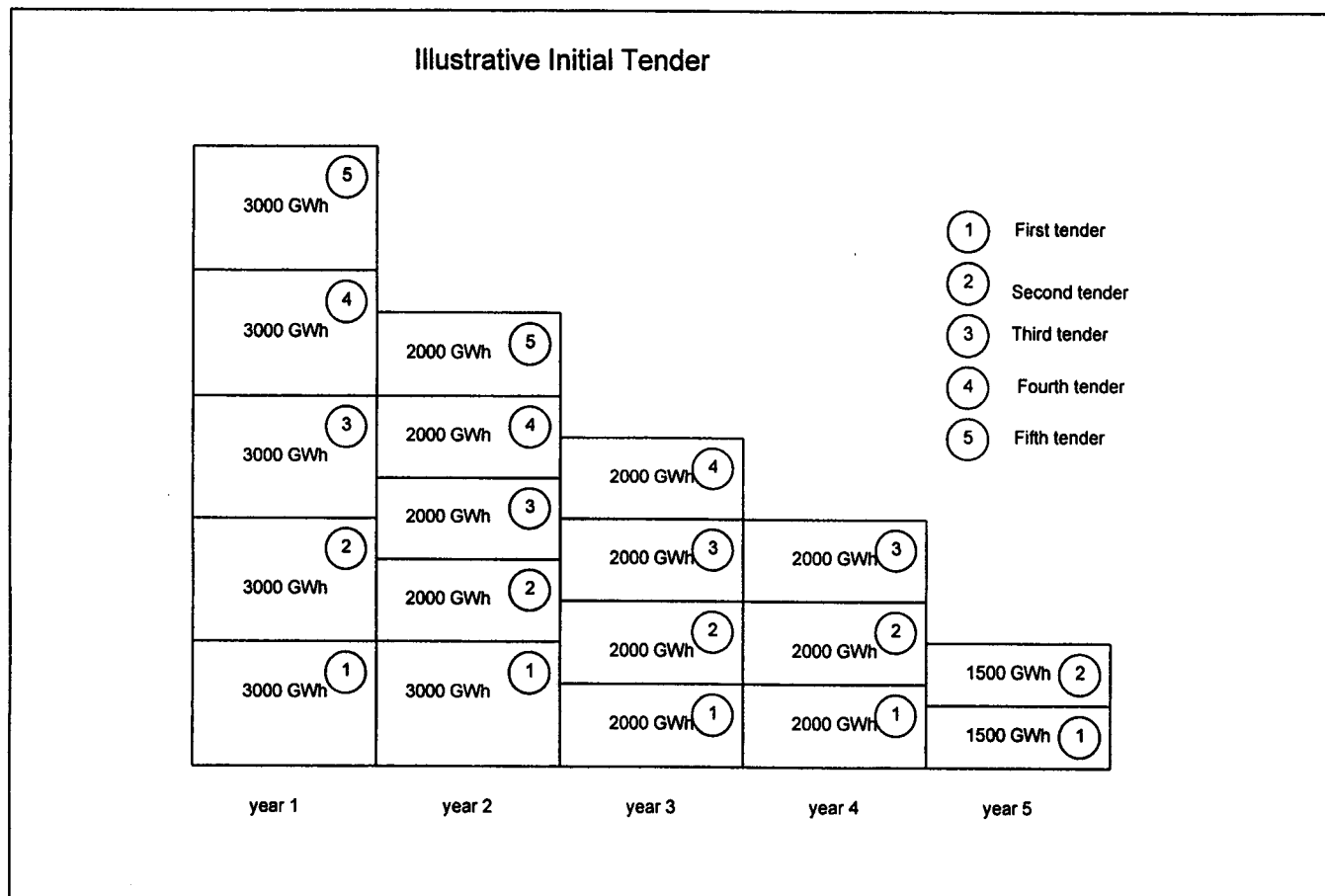
5. ECNZ may choose, for commercial reasons, to offer

more than the quantities indicated in the table, from time to time.

Offers

6. The initial offer will be made by way of tender in five tranches at monthly intervals (or possibly shorter intervals for the later tranches). Each tranche will consist of a

combination of year 1, year 2, year 3, year 4 or year 5 blocks. The minimum block size will be 1000 GWh and the maximum block size will be 5000 GWh. An illustrative example of the initial offer is outlined in the following figure.



7. ECNZ's customers will have more than one opportunity to tender for blocks of electricity in any one year.

8. The initial offer will be put in place when the new SOE is in a position to offer contracts but not later than 1 December 1995. ECNZ will continue to offer contracts to cover the intervening period.

9. Following the initial offer, ECNZ will use a range of normal contract processes (which may include an ongoing tender process) to maintain the profile set out in paragraph 2.

10. ECNZ will be responsible for setting its offer prices, including reserve prices for electricity offered by tender.

11. During the establishment period, ECNZ will consult the shareholding Ministers on its proposed pricing.

Duration

12. ECNZ's obligation to offer contracts in accordance with this Appendix will cease once ECNZ's share (including its interest in joint ventures referred to in Appendix 4 and in companies ring-fenced under Appendix 5) of the total New Zealand generating capacity measured in MW capacity terms is 45% or less of the total, and that share has been verified by the Secretary of Commerce.

Explanatory note:

Under the measures set out in this Memorandum, ECNZ will continue to have a significant market share.

Its incentive to unduly influence the spot price will be

substantially reduced if, in a year ahead, a large proportion of its firm capacity is covered by contracts. The mechanism outlined above will enable wholesale buyers to—

- *limit ECNZ's incentives to unduly influence the spot price by contracting with ECNZ up to the levels specified in paragraph 2; and*
- *establish electricity prices for at least the initial offer phase by competitive tendering; and*
- *insure themselves against major price fluctuations.*

Wholesale buyers will be able to indicate in a formal competitive process the value they put on electricity over different time-frames.

This is a significant step towards a competitive wholesale electricity market.

APPENDIX 7

Revisions to ECNZ'S Statement of Corporate Intent

The ECNZ Board will amend ECNZ's Statement of Corporate Intent as set out below (deletions from the 1994/95 SCI are ~~crossed-out~~ and insertions *italicised*):

"A: Commercial Objectives of the Corporation

The Directors *intend acknowledge and accept the requirement of shareholding Ministers for the Corporation to operate as a successful business and, in particular, to be*

as profitable and efficient as comparable businesses that are not owned by the Crown, as is required in Part I of the Act. The Corporation aims to increase its Shareholder value at a rate similar to large comparable businesses.

To achieve this, the Corporation intends to:

- (a) undertake new investments which over their life are:
- (i) aimed at yielding a return at least equal to the Corporation's cost of capital, including a normal commercial profit;
 - (ii) the least-cost options *available to the Corporation*;
 - (iii) controlled in a manner which will maximise the

commercial value of the enterprise, by ensuring that the addition of new equipment is related as closely as possible to actual and forecast market requirements; and

- (iv) considered to be in the best commercial interests of the Corporation.
- (b) ~~take account of the pricing policies which might be pursued by a market competitor in a comparable situation.~~
- (c) adopt a commercial pricing strategy which includes giving clear market signals to customers, with appropriately flexible contractual options; . . ."

APPENDIX 8

Timetable

This timetable sets out various tasks for implementing the measures set out in Part 1 of the Memorandum of Understanding, and the allocation of responsibility and target completion date for each task.

Target Date	Task	Responsibility
Early June 1995	Ministers commence process for Treaty consultations	Ministers
1 July 1995	Development Group formally established	Ministers
1 July 1995	Work commences on loan and funding agreements	Development Group, Treasury
1 July 1995	Work commences on sale and purchase agreement	Development Group, ECNZ
31 July 1995	EMCO and Trans Power start regular (2 monthly) briefings to Minister of Energy on pool development	EMCO, Trans Power
31 July 1995	Development Group progress report	Development Group
31 August 1995	Development Group progress report	Development Group
September 1995	Negotiation of draft loan and funding agreements completed	Development Group, Treasury
September 1995	Negotiation of draft sale and purchase agreement completed	Development Group, ECNZ, Officials
September 1995	Development Group provides certification to Government on public policy objectives	Development Group
30 September 1995	EMCO and Trans Power progress report on pool development	EMCO, Trans Power
Early October 1995	Final decision on reform package, taking into account results of Treaty consultation	Cabinet
<i>If Cabinet decides to establish the new SOE</i>		
Early October 1995	Order in Council to establish new SOE	Executive Council
Early October 1995	Appoint board of directors for new SOE	Ministers
Early October 1995	Partial capitalisation of new SOE	Shareholding Ministers, new SOE
6 October 1995	ECNZ informs market of contract tender arrangements	ECNZ
31 October 1995	New SOE progress report	New SOE
15 November 1995	New SOE and ECNZ supply draft SCIs to shareholding Ministers	ECNZ, new SOE
30 November 1995	New SOE progress report	New SOE
30 November 1995	EMCO and Trans Power progress report on pool development	EMCO, Trans Power
1 December 1995	Tender for ECNZ contracts commence	ECNZ
1 December 1995	New SOE offers contracts	New SOE
15 December 1995	ECNZ and new SOE submit final SCIs	ECNZ, new SOE
31 January 1996	Ringfence and cap restraints commence	Shareholding Ministers
31 January 1996	New SOE fully capitalised	Shareholding Ministers, Development Group
31 January 1996	ECNZ reregistration completed	ECNZ
31 January 1996	Transfer of assets to new SOE: new SOE fully operational	Ministers, ECNZ, new SOE
31 January 1996	EMCO and Trans Power progress report on pool development	EMCO, Trans Power
1 February 1996	Pool operational (interim)	EMCO, Trans Power
30 April 1996	EMCO and Trans Power commence quarterly progress reports on pool development	EMCO, Trans Power
1 October 1996	Pool capability for fully functioning market	EMCO, Trans Power
1 August 1997	Complete sale of small hydros	ECNZ



