
Submission

**Proposed Compliance Requirements for the
2015-2020 Default Price-Quality Paths for
Electricity Distributors**

15 August 2014

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1 EXECUTIVE SUMMARY

Aurora considers that the Commission should move toward greater clarity and certainty with regard to compliance enforcement. We recommend that the Commission take steps to develop enforcement guidelines for the DPP that better reveals the Commission's intentions with regard to compliance.

We are concerned that features of the Commission's proposed revenue-linked service quality scheme alter the general stability of the quality path, resulting in a fundamentally harder quality standard to achieve than under the current regime, and which is not reflected in any price trade-off. To this end, we submit that the Commission should consider a cap-based compliance standard, under the present two out of three year assessment rule.

In our view, the Commission's proposal concerning pass-through and recoverable costs is unduly complex and comparatively inefficient. With respect to the proposed transmission balance, the proposal is inappropriately time-bound and inconsistent with previous decisions that allow arrangement to span across regulatory control periods. We consider that wash-up mechanisms remain the best option for the treatment of forecast error for pass-through and recoverable costs.

Aurora has concerns that the proposed requirement to seek Commission approval for certain recoverable costs is overly complex, particularly where there are defined rules for treatment, which can then be supported at the time of compliance statement publication by Director certification and audit assurance. We submit that prior approval is generally unnecessary when the aforementioned conditions exist.

The proposal to limit CPP applications to two, narrow, one-week windows unduly constrains when EDBs can apply for CPPs and, in our view, is not in the long-term interests of consumers. Such restrictions come at a cost and could result in EDBs having to wait up to an extra six months (on top of the time it took to prepare the CPP) to submit a CPP application. We consider that greater flexibility should be considered.

2 INTRODUCTION

Aurora Energy is pleased to submit on the Commerce Commission's "Proposed Compliance Requirements for the 2015-2020 Default Price-Quality Paths for Electricity Distributors", 18 July 2014. We support the submissions of the ENA and PricewaterhouseCoopers on this matter.

We have previously submitted, on 15 August 2014, on the Commission's "Proposed Default Price-Quality Paths for Electricity Distributors from 1 April 2015", and "Low Cost Forecasting Approaches for Default Price-Quality Paths" consultation papers (both released 4 July 2014). This submission, by necessity, reinforces our views expressed in that submission.

No part of our submission is confidential and we are happy for it to be publicly released.

If the Commission has any queries regarding this submission, please do not hesitate to contact Alec Findlater:

Alec Findlater
Commercial Manager
Delta Utility Services
alec.findlater@thinkdelta.co.nz
(03) 479 6695
(027) 222 2169

3 COMPLIANCE ENFORCEMENT

Greater clarity around compliance enforcement would be desirable

Aurora considers that the Commission should move toward greater clarity and certainty with regard to compliance enforcement.

We note, with concern, the content of compliance enforcement statements made by the Commission, such as those concerned with quality standards:

“Failure to meet the SAIDI target or SAIFI target would constitute non-compliance with the quality standards. The Commission may take enforcement action and seek pecuniary penalties under section 87 of the Commerce Act, or criminal sanctions under section 87B of the Commerce Act, for failure to meet the quality standards.”

“In the case of unintentional breaches, we do not propose to take enforcement action for performance worse than the quality targets but still the below the cap except in exceptional circumstances...”¹

As a representative example, we consider these statements to be unnecessarily vague, and somewhat contradictory. As an illustration, we question why the Commission would consider that any EDB would intentionally breach the quality standards? Further, the Commission could be clearer on such matters as what would constitute exceptional circumstances.

We recommend the Commission take steps to develop enforcement guidelines for the DPP that better reveals the Commission’s intentions with regard to compliance.

While the Commission has generic Enforcement Criteria to assist it in its discretionary activities when making decisions on whether to open an investigation, and what enforcement action it will take at the end of an investigation, and Enforcement Response Guidelines, it also has specific compliance guidelines on matters including Fair Trading Act, credit fees under the Credit Contracts and Consumer Finance Act, etc.

Aurora agrees with Alpine Energy’s views on the need for guidelines on compliance enforcement:²

“While the process and issues paper does not invite views on the release of enforcement guidelines we would like to take this opportunity to once again raise our concerns about the lack of guidelines with the Commission.

Uncertainty around the process that the Commission will take when it exercises its enforcement discretion presents a serious concern for us. Part 4 of the Commerce Act gives the commission significant discretion to take enforcement action for breaches. Regulated suppliers currently only have limited precedent upon which to base how the Commission is likely to exercise its discretion when taking enforcement action.

To date the Commission has released two enforcement responses for breaches of the DPP at the 2011 and 2012 assessment dates. The Wellington Electricity Lines Limited settlement agreement provides some indication of the process that the Commission will take. However the Orion New Zealand limited warning letter provides none.

In the process and issues paper the Commission expressed the view that “[e]nforcement guidelines and informative precedents will contribute to reducing this uncertainty..., which is encouraging as it indicates that the Commission may be considering the release of enforcement guidelines.

We are of the view that enforcement guidelines will go a long way in providing regulated suppliers, including EDBs, with an appropriate level of certainty. And agree that while enforcement guidelines will reduce uncertainty the guidelines will never eliminate uncertainty entirely. Accordingly, we encourage the release of enforcement guidelines for the start of the next regulatory period”

¹ Commerce Commission, Proposed Quality Targets and Incentives for Default Price-Quality Paths from 1 April 2015, 18 July 2014, paragraphs 2.19 and 2.20.

² Alpine Energy, Submission to the Commerce Commission on Default Price-Quality Paths from 1 April 2015 for 17 electricity distributors: Process and issues paper, 30 April 2014, paragraphs 4.1 – 4.5.

4 REVENUE-LINKED SERVICE QUALITY SCHEME

As noted in our submission on the general principles of the proposed DPP reset and the proposed quality targets in particular, Aurora has significant concerns regarding the compliance aspects of the proposed revenue-linked service quality scheme.

In Aurora's view, features of the Commission's proposed revenue-linked service quality scheme alter the general stability of the quality path, resulting in a fundamentally harder quality standard to achieve than under the current regime, and which is not reflected in any price trade-off. In brief, these features include:

- **Transition to a SAIFI trigger for maximum event day normalisation.** The Commission has proposed that this is necessary due to concerns, unsubstantiated in practice, that EDBs have no incentive to restore service as quickly as possible once a SAIDI maximum event day has occurred. Unfortunately, this proposal appears to have been formulated arbitrarily, without consideration of the underlying relationship between SAIDI and SAIFI that exists on each network (for Aurora, SAIDI is dominant). The approach is inconsistent with the IEEE 1366 standard (which informs and underpins the Commission's approach to quality of service regulation) that considers that "The ability of an index to reflect customer cost of unreliability indicates the best one to use for MED identification." and "Thus, a duration-related index will be a better indicator of total costs than a frequency-related index like SAIFI or MAIFI." Aurora considers that the Commission's proposal to materially deviate from the IEEE 1366 standard risks compromising the integrity of EDB price-quality regulation.
- **Removal of breach amounts in target calculations.** The Commission has proposed that EDBs that breached the quality standards during the current regulatory control period should have the amount of the breach deducted from the target calculation. Aurora considers that the proposal is inconsistently applied, in that it penalises only non-compliance in the current regulatory control period, rather than throughout the proposed reliability reference period. Additionally, it does not consider whether there has been any veridical degradation in underlying service quality over time. Further, the proposal amounts to additional enforcement action for those EDBs that breached during the current regulatory control period, in such a manner as to offend the principles of natural justice. Finally, the quality target reset mechanism tends to apply a "sinking lid" that ratchets up service quality requirements over time. Like all sinking lid mechanisms, this could ultimately result in targets that are unsustainable (unless offset by an exponential increase in reliability investment). Aurora considers that the Commission's proposed breach adjustment simply accelerates the path toward the potential unsustainability tipping point.
- **A target-based compliance standard.** Since the targets have been derived as a simple arithmetic average of historic data, the law of averages would dictate that EDBs should expect to exceed their targets about 50% of the time. This is compounded, in Aurora's case, by the fact that the proposed transition to a SAIFI trigger for maximum event day normalisation means that, going on historical data, any future normalisation is unlikely.

A target-based compliance standard

Aurora's preference is to have non-compliance judged on the basis of the incentive cap being exceeded, with a breach of regulation being determined on the current two out of three year assessment rule. While we do not like the element of chance that would return as a result of re-introducing the two out of three year assessment rule, it may have the effect of suppressing false positives, in terms of identifying material deterioration of reliability performance

5 WASH-UP PASS-THROUGH AND RECOVERABLE COSTS

In Aurora's view, the Commission's proposal concerning pass-through and recoverable costs is unduly complex and comparatively inefficient. With respect to the proposed transmission balance, the proposal is inappropriately time-bound and inconsistent with previous decisions that allow inter-regulatory control period arrangements.

A wash-up mechanism is the best option for dealing with uncertainty about pass-through and recoverable costs

Aurora agrees with the Commission's view that "In principle, distributors should be able to recover pass-through and the allowed recoverable costs in full".³ This is consistent with "reasonable investor expectations". As Telecom has noted: "reasonable investor expectations are that they will receive a normal return over the life of assets ..."⁴

We also agree with the Commission that full recovery of pass-through and recoverable costs is "problematic" because "First, distributors have difficulty forecasting the amounts required to cover pass through and recoverable costs" and "Secondly, the recovery of the amounts required to cover pass through and recoverable costs are associated with some degree of volume risk".⁵

Aurora specifically incorporates "head-room" of \$200,000 into recovery of pass-through and recoverable costs to avoid the risk of breaching our price path.⁶

Aurora submits that there are no legitimate benefits to consumers from regulated suppliers being exposed to the risk of under-recovery of pass-through and recoverable costs. If a regulated supplier is not able to fully recover these costs, it may mean artificially lower prices to consumers, but so would any policy that involves setting the DPP deliberately below cost. This is a short-term and opportunistic benefit only for consumers. Any aspect of the DPP that systematically undermines the ability of regulated suppliers to fully recover their costs, including a normal rate of return, comes at a cost to consumers of potentially interfering with the ability of regulated suppliers to efficiently invest and maintain their networks (which is particularly problematic where there is an identified need to increase opex in order to improve service quality, as is the case with Aurora). This is a particular issue, given that the Commission has not made additional allowances for uncertainty, beyond allowing a 75th percentile WACC that it now proposes to reduce to the 67th percentile.

Commerce Commission hybrid, ENA and Vector options

We welcome the efforts from the ENA and Vector to propose potential solutions that the Commission could adopt. We consider that these efforts are very constructive.

Aurora supports the ENA proposal. We consider the Vector proposal to be a second-best option.

We believe a wash-up mechanism should be introduced, under which any under or over-recovery of notional revenue, adjusted for the time-value of money, would occur following an assessment period. We caution that the Commission should avoid overcomplicating the wash-up mechanism.

We also support the ENA proposal that the wash-up not be constrained to specific causes, such that under or over-recovery would not result in a breach of the price path, but would instead require

³ Commerce Commission, Proposed Default Price-Quality Paths For Electricity Distributors From 1 April 2015, 4 July 2014, paragraph 5.2.

⁴ Telecom, UCLL and UBA FPP: consultation on regulatory framework and modelling approach, 6 August 2014, paragraph 85.

⁵ Commerce Commission, Proposed Default Price-Quality Paths For Electricity Distributors From 1 April 2015, 4 July 2014, paragraph 5.3.1.

⁶ Aurora Energy, Submission to the Commerce Commission on its Draft Decisions Paper (July 2011) on 2010-15 Default Price Quality Path for Electricity Distribution, 24 August 2011, section 3.2.2.

an adjustment at a later time. We agree there are other forecast risks than just for pass-through and recoverable costs, such as the impact of tariff rebalancing, which should be addressed.⁷

We do not believe there is any detriment to consumers from the ENA proposal, as long as the time-value of money is set appropriately.

We consider the ENA option to be the best option for ensuring that regulated suppliers are able to fully recover their allowable revenues. Full recovery is particularly important given the Commission does not provide any allowance for uncertainty (other than adoption of the 75th percentile for WACC).

The Commission could limit wash-up to pass-through and recoverable costs rather than the entire allowable revenues. The ENA option would then, in effect, be equivalent to Vector's proposal.

The Commission has expressed concern that Vector's proposed approach (and, therefore, presumably the ENA's) provides "distributors with a substantial degree of flexibility in how they set the transmission component of prices" and "that this may give distributors too much flexibility in calculating the annual amount they will recover for transmission charges".⁸

This concern is readily addressed without having to adopt the Commission's hybrid option.

There are various safe-guard options the Commission could adopt; including to avoid the risk of regulated suppliers systematically over-recovering in earlier years.

The ENA has proposed introducing a penalty where variances between allowable notional revenue and notional revenue exceed a specific threshold. Taken to the extreme, the Commission could allow for wash-up only within a certain band of tolerance; i.e., the Commission's suggested "limit on the transmission balance within a designated percentage range of known (i.e., lagged) quantities".⁹

Another option would be to apply an asymmetric time-value of money; i.e., the discount rate applied for over-recovery could exceed the discount rate applied for under-recovery. This would provide an incentive for regulated suppliers to err on the side of under-recovery.

If consumer welfare is an issue that is constraining the extent to which the Commission is willing to allow wash-up, we would note that the interest rate(s) for under and over-recovery could be set at a level so that consumers would actually be better off if regulated suppliers under or over-recover as it would reduce the NPV of their network charges.

We would expect that use of financial penalties (slightly higher interest rate for over-recovery) would better serve consumer interests than arbitrary quantified limits on under/over-recovery.¹⁰

We accordingly consider the ENA wash-up option, and/or Vector's proposed approach, warrant further consideration by the Commission.

If the Commission decides to reject the ENA and Vector options, even with the safe-guards we have suggested, then we would support the Commission's hybrid as a third-best option.

⁷ Electricity Networks Association, Submission on default price-quality paths from 1 April 2015 for 17 electricity distributors: process and issues paper, 30 April 2014, paragraph 134.

⁸ Commerce Commission, Draft reasons paper, Proposed Compliance Requirements for the 2015-2020 Default Price-Quality Paths for Electricity Distributors, 18 July 2014, paragraph 3.52.

⁹ Commerce Commission, Draft reasons paper, Proposed Compliance Requirements for the 2015-2020 Default Price-Quality Paths for Electricity Distributors, 18 July 2014, paragraph 3.53.2.

¹⁰ Consumers could actually then prefer it if their distributor over-recovered pass-through and recoverable charges (Vector option) or allowed distribution revenue (ENA option).

Finite transmission balance

The Compliance Requirements paper states that, under the hybrid, “In order to comply with the price path, the transmission balance at the end of the regulatory period must be less than or equal to zero. Under the proposed approach, a negative balance (of unrecovered charges) is not carried over into the next regulatory period”.¹¹ We cannot understand why the Commission would propose this. The Commission provides no explanation to comment on. The Commission has provided for claw-back to extend beyond a single regulatory period, so why not other recoverable costs?

Effectively, it is as if the Commission’s proposals apply for four years only, rather than the full five years of each regulatory period. Aurora supports allowing a negative balance (of unrecovered charges) to be carried over into the next regulatory period, and also supports a positive balance (of over-recovered charges) to also be carried over.

In summary, our preference is for the Commission to adopt a wash-up mechanism where unders and overs are recompensed in subsequent periods (including subsequent regulatory periods). We do not see any downside to consumers from this approach, so long as an appropriate interest rate(s) is applied to any under or over recovery.¹²

Ensuring ACOT payment arrangements remain practicable and are to the long-term benefit of consumers

Clause 3.1.3(1)(f) of the Electricity Distribution Services Input Methodologies Determination 2012 provides that avoided cost of transmission (ACOT) payments are a recoverable cost, and it is permissible to recover “an amount equal to transmission costs that an efficient market operation service provider (as ‘market operation service provider’ is defined in the Electricity Industry Participation Code) is able to avoid as a result of the connection of distributed generation determined in accordance with Schedule 6.4 of Part 6 of the Electricity Industry Participation Code”.

The Commission proposes to amend clause 3.1.1(1)(f) to”

*“a **distributed generation allowance**, ...” where **distributed generation allowance** means any positive allowance for costs incurred and amounts payable or negative allowance for amounts receivable in relation to the regulation of avoided transmission charges arising from distributed generation, including embedded or notionally embedded generation, made under:*

“(a) Schedule 6.4 of Part 6 of the Electricity Industry Participation Code, or

“(b) the Electricity Industry Act 2010.”

These changes address a number of issues:

- They avoid the potential for conflict between “an amount equal to transmission costs that an efficient market operation service provider (as ‘market operation service provider’ is defined in the Electricity Industry Participation Code) is able to avoid as a result of the connection of distributed generation” and Schedule 6.4 of Code that could arise if Schedule 6.4 is amended.
- They correct the current error of referring to “market operation service provider” [there is no such thing] rather than “electricity distributor”; and
- They ‘future proof’ against changes where ACOT payments are not necessarily specified by the Authority under Schedule 6.4 of the Code.

¹¹ Commerce Commission, Draft reasons paper, Proposed Compliance Requirements for the 2015-2020 Default Price-Quality Paths for Electricity Distributors, 18 July 2014, paragraph 3.50.

¹² As per the approach taken to claw-back.

There are some potential issues that the Commission should consider though.

Any changes to ACOT payment arrangements need to recognise/grandfather existing ACOT contractual arrangements between distributors and distributed generators. Otherwise, distributors could end up in a situation where, through no fault of their own, they are making payments based on pre-existing ACOT payment Code requirements (until contract expiry) that are not able to be fully recovered.

What would happen if the Commission and Electricity Authority had different views as to whether a distributor's ACOT payments complied with the Electricity Authority's Code?

Aurora does not believe that the current Code provisions for ACOT payments are to the long-term benefit of consumers, as they provide that the distributed generator receives the full benefit of any avoided transmission, only pays incremental cost, and does not have to contribute to the distributors fixed and common costs. This means consumers do not share any of the efficiency benefits of distributed generation, contrary to the purpose in section 52A(1)(c) of Part 4 of the Commerce Act.

Furthermore, what would happen if the Electricity Authority amended the existing Distributed Generation/ACOT payment provisions in Schedule 6.4 of the Code in a way that is not, and/or the Commission was not satisfied is, practicable to comply with or to the long-term benefit of consumers?

For example, Aurora considers that the correct interpretation of the current Schedule 6.4 of the Code is to base the ACOT payments on the transmission charges distributors actually avoid due to distributed generation.

The Electricity Authority has expressed concerns about basing ACOT payments on actual avoided transmission charges rather than the (unknown) costs Transpower would avoid. (This will be different to the extent that the TPM charges are not fully cost reflective.)

In the Electricity Authority's ACOT Working Paper it made the following comments:

"A practice has arisen whereby a majority of distributors calculate their ACOT payments according to the transmission charges they avoid (as a result of the operation of DG on their network) rather than on the basis of the economic costs avoided."¹³

The Authority considers that an approach in which payments to DGs are based on avoided economic costs, rather than avoided transmission charges to the distributor, would better reflect the Authority's statutory objective2 "to promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers". This would include consideration of avoided costs to both transmission and distribution.

On this basis, the Authority's preliminary view is that the majority of ACOT payment schemes could be improved through:

- *a greater focus on economic costs rather than the pass through of avoided transmission charges to consumers*
- *a greater consideration of any benefits accruing to distribution networks, if any."¹⁴*

In Aurora's view it would be entirely impractical to base ACOT payments on Transpower's actual avoided costs. We do not know what Transpower's actual avoided costs are, and could not reasonably be expected to know. All we can do is respond to Transpower's transmission charges.

¹³ Electricity Authority, Transmission Pricing Methodology: Avoided cost of transmission (ACOT) payments for distributed generation, 19 November 2013, paragraph 1.2.

¹⁴ Electricity Authority, Transmission Pricing Methodology: Avoided cost of transmission (ACOT) payments for distributed generation, 19 November 2013, paragraphs 1.16 and 1.17.

Market participants should be able to assume that responding to pricing signals will lead to more efficient outcomes.¹⁵

The Commission should liaise closely with Electricity Authority to ensure appropriate delineation of responsibilities, and that both regulators are satisfied any prospective changes to Schedule 6.4 of the Code would satisfy the purposes in section 52(A)(1) of the Commerce Act and section 15 of the Electricity Industry Act. In particular, any arrangements need to reflect it is the Commission's responsibility to approve the ACOT for treatment as a recoverable cost amount not the Electricity Authority.

This issue highlights some of the downside of having two separate regulators dealing with interrelated aspects of economic regulation of electricity distribution.¹⁶

¹⁵ In this respect, we note that Transpower is presently undertaking an operational review of the TPM and has identified it may be desirable to amend the RCPD interconnection charges to make them less avoidable/more fixed. This could result in better alignment between avoided transmission charges and Transpower's actual avoided transmission costs.

¹⁶ The interrelationship between sections 32(2)(b) and 34(1)(a)(v) of the Electricity Industry Act is particularly clumsy.

6 COMMISSION APPROVALS

Aurora has concerns that the proposed requirement to seek Commission approval for certain recoverable costs is overly complex, particularly where there are defined rules for treatment, which can be supported at the time of compliance statement publication by Director certification and audit assurance. Further, there can be practical commercial and governance implications, as noted below:

Practical implications of Commission approval of avoided transmission

The Commission has proposed “updating the recoverable cost term relating to avoided transmission charges as a result of distributed generation (also referred to as embedded generation) to require Commission approval”¹⁷.

The Commission should understand that the approval process has real implications for EDBs, and the Commission, in terms of timeliness of response. Distributors are normally advised of changes to transmission expenses in November annually. Most EDB’s use-of-system agreements with electricity retailers specify that prices changes must be advised at least 40 working days before they take effect. In Aurora’s case, we aim to have price changes approved by the Board in late January, with price changes notified to retailers at the end of January/start of February.

It is likely that, in order for Aurora to complete the re-pricing process within contractual and governance timeframes, we would require Commission approval by the end of December annually.

Approval of Aurora’s avoided transmission charges for the first assessment period is likely to be much compressed. Distributors have been advised by Transpower¹⁸ that they are unlikely to advise pricing for the first assessment period until 15 December 2014, as a result of the Commission’s proposal to defer the determination date of the regulatory WACC by one month¹⁹.

Aurora’s view is that the Commission must be mindful of the contractual and governance constraints on distributors, with respect to price changes, and must be confident that it is able to adequately resource its proposed approval process, and provide responses to distributors in a timely manner.

We do not support Commission approvals for recoverable costs that are rule-bound in their calculation, and which can be verified by Director certification and audit assurance at the time the compliance statement is published.

¹⁷ Commerce Commission, Draft reasons paper, Proposed Compliance Requirements for the 2015-2020 Default Price-Quality Paths for Electricity Distributors, 18 July 2014, paragraph 3.76

¹⁸ Transpower, Customer Update, 7 August 2014

¹⁹ Proposed amendment to the WACC determination date for electricity lines services, including Transpower, 4 August 2014

7 CUSTOMISED PRICE-QUALITY PATHS

CPP windows should be wider and more flexible

The Commission is proposing to limit CPP applications to two narrow (one week each) windows. The rationale is that “the Act allows us to prioritise applications where we receive more than four in one year. In order to undertake this prioritisation exercise, we need all the applications to be submitted at the same time”.²⁰

Aurora considers that this unduly constrains when EDBs can apply for CPPs, and is not in the long-term interests of consumers.²¹

The Commission should also be mindful that the limited windows come at a cost.

They could result in EDBs having to wait up to an extra six months (on top of the time it took to prepare the CPP) to submit a CPP application. Given that the Commission does not fully compensate regulated suppliers for foregone revenue during the period between a catastrophic event, such as the Christchurch earthquakes, and the CPP determination, this narrow window could add considerable cost and risk for EDBs.

In years where there are no more than four CPP applications for the same type of regulated good or service, the imposition of narrow windows to enable the Commission to prioritise applications has no value. This is all years since the new Part 4 was introduced as there has only been one CPP application.

In our view, the costs of delay (up to six months) outweigh the hypothetical benefits of being able to prioritise CPP applications on a different basis to ‘first come, first served’.

At the very least, we suggest that the Commission widens the window beyond one-week (say to a month); and/or provide a provision allowing exemptions from the CPP windows; e.g., if other EDBs supported an EDB being able to apply for a CPP outside of the normal windows.

The Commission could also consider adopting a prioritisation rule allowing applications to be received after the end of the two windows, but before the end of the year, with any such applications prioritised on a first come, first served basis.

²⁰ Commerce Commission, Draft reasons paper, Proposed Compliance Requirements for the 2015-2020 Default Price-Quality Paths for Electricity Distributors, 18 July 2014, paragraph 8.5.

²¹ Prioritisation should only be applicable for electricity distribution, as there aren't four gas distribution or four gas transmission businesses.