

ATTACHMENT 8.8

ANCILLARY NETWORK SERVICES PROPOSAL

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1. Introduction

In this attachment we explain:

1. The Ancillary Network Services (ANS) that we provide, against the list of services that the AER has defined as requiring Alternative Control services.
2. The activities undertaken by us to provide our customers with ANS and their associated operating costs.
3. The approach we have used to determine our revenue requirements to recover the efficient costs of providing ANS.
4. The methodology we have used to set prices.

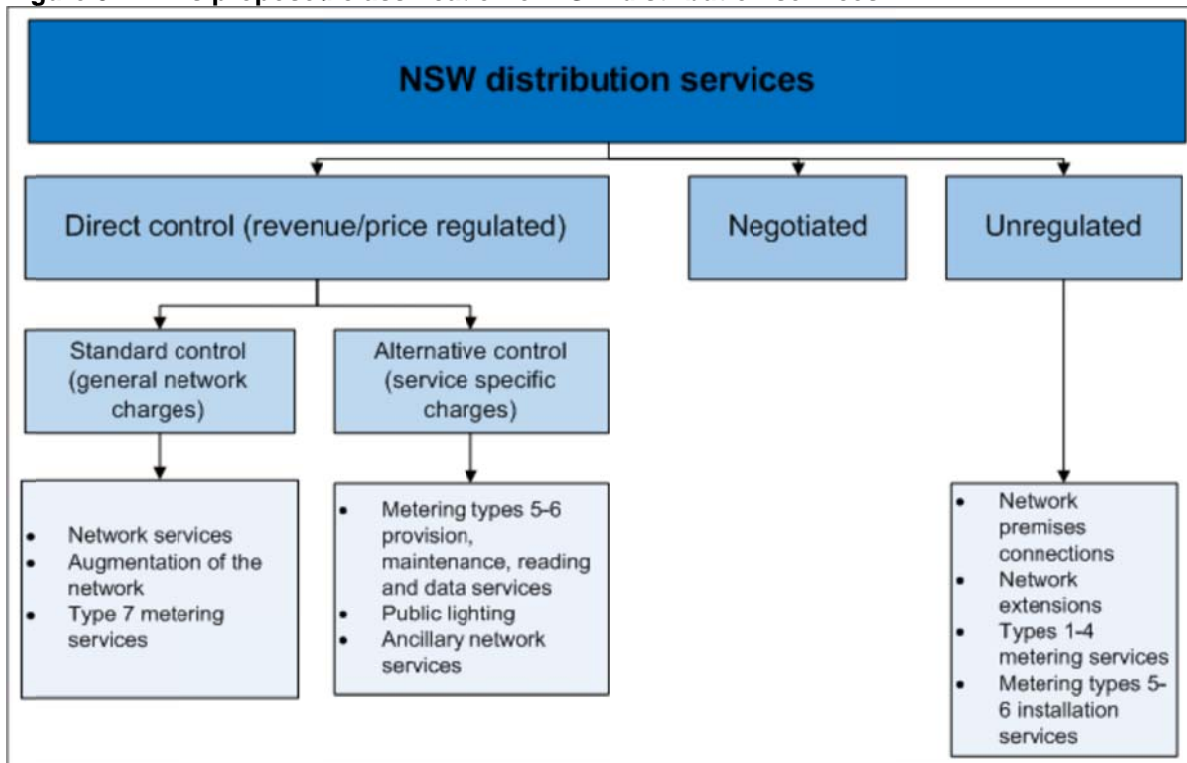
As this is the first time that we are required to separately price some of the ANS, we have sought to give effect to the Australian Energy Regulator’s (AER’s) intent when identifying the classification of these ANS. Specifically, our approach seeks to facilitate contestability and provide a cost reflective price for the ANS that are provided to specific customers.

2. About Ancillary Network Services

Ancillary Network Services is one of the terms developed by the Australian Energy Regulator (AER) to group specific classes of services provided by NSW distribution businesses. There are separate pricing methodology papers for Metering Services and Public Lighting which are special classes of Ancillary Network Services.

The AER determines the form of regulation that will apply to those service groupings for a 5-year period. The form of regulation governs the manner in which we can collect revenue from customers for specified classes of services. ANS are defined in the Australian Energy Regulator’s (AER) Stage 1 - Framework and Approach Paper. In that paper, the AER has specified that ANS will be priced as an Alternative Control Service. See Figure 3, page 15 of the Stage 1 paper (included below):

Figure 3: AER's proposed classification of NSW distribution services



Source: AER ¹

¹ AER Stage 1 Framework and Approach Paper, Ausgrid, Endeavour Energy and Essential Energy – March 2013 available at www.aer.gov.au

A list of the services grouped as ANS is listed in the Stage 1 Framework and Approach paper on pages 81 to 84 and included in the table of services listed in the pricing table in section **Error! Reference source not found.**

The AER has decided that ANS will be separately regulated from 1 July 2014.

In Figure 3 Above, the AER has specified that the ANS will be priced as Alternative Control Services (ACS). ACS is one of the service groups priced under Direct Control Services within the National Electricity Rules (NER). Clause 6.2.2 of the NER requires the AER to classify the Direct Control Services into either Standard Control Services or Alternative Control Services having regard to:

- (1) the potential for development of competition in the relevant market and how the classification might influence that potential; and
- (2) the possible effects of the classification on administrative costs of the *AER*, the *Distribution Network Service Provider* and users or potential users; and
- (3) the regulatory approach (if any) applicable to the relevant service immediately before the commencement of the distribution determination for which the classification is made; and
- (4) the desirability of a consistent regulatory approach to similar services (both within and beyond the relevant jurisdiction); and
- (5) the extent the costs of providing the relevant service are directly attributable to the person to whom the service is provided; and
- (6) any other relevant factor.

The AER therefore requires the services defined in this paper to be priced in accordance with the terms set out in those rules.

The Stage 1 Framework and Approach paper defines the pricing methodology for two periods within the next five year regulatory cycle as follows.

- > The transitional regulatory control period – 1 July 2014 to 30 June 2015; and
- > Subsequent regulatory control period – 1 July 2015 to 30 June 2019

The pricing methodology for these two periods is different for existing services, and is separately defined later in this paper.

3. Drivers for the distributors provision of ANS

One clear distinction between the services defined as Alternative Control Services and Standard Control Services is that the services specified in this document and defined as ANS result in the incurrence of costs that are directly attributable to the person to whom the service is provided. This is specified in Clause 6.2.2 (c) (5) of the NER.

Therefore, the costs incurred for the provision of these services are the principle driver of the prices charged for the services provided. Most of these costs are in the nature of operating costs for resources deployed in the delivery of the services. The resources deployed include field staff, office based staff and a fleet cost for field related services. Relevant overheads are included in accordance with the Cost Allocation Methodology approved by the AER [

The AER's Stage 1 Framework and Approach Paper lists the services to be provided under an ANS. Essential Energy provides most of these services to its customers and prices have been developed that meet the AERs requirements in this regard. The activities undertaken by Essential Energy consists of the provision of engineering and technical skill labour, use of vehicles and some plant and equipment, and some materials to perform the activities necessary to complete the tasks required to safely and efficiently deliver ANS to the customer base.

In order to provide cost reflective ANS prices, appropriate cost drivers must be identified in order to provide the relevant service.

Essential Energy has identified cost drivers through the application of this pricing methodology and identifies these drivers below. The approach has adopted pricing approaches which strike a balance between the ability to price a service and therefore provide a price to a customer on a per service basis and prepare a price per hour for the provision of the technical expertise which will involve Essential Energy providing a quote based on the estimated time to complete the service. The prices will in both cases be cost reflective, but in the quoted services, they will recognise the range and complexity of each customer's needs. These are explained further below.

- > **Per service** – some costs are closely correlated to the number of services delivered and each instance varies little in the resource required. For example a Special Meter read incurs costs for the attendance at a customer's premises (including time to travel to the premise) to read the meter and enter the data into a system for an out of cycle meter read. The average time to read and enter the data is used as an input to the calculations. The number of requests for this service drives this cost to some extent. Essential Energy will bear the cost without opportunity for recovery if cost reflective prices are not charged, and for any inefficient delivery of this service.
- > **Per hour** – some costs are more dependent on the specifics of the request for service, and the number of hours it takes to complete the task varies more widely. For example, the escort of a high load will incur costs that vary with the distance and speed travelled by the high load. In this case, the driver of the costs will be the number of hours applied to deliver the service, multiplied by the cost per hour. The volumes are outside of Essential Energy's control and to quote a fixed price per service would penalise some customers and benefit others. The per hour rate will therefore be applied to the customer's needs and the time necessary to complete the task will be provided in a quote to the customer.

4. Costs to deliver ANS

The costs needed to deliver ANS consist of mostly operating costs. There is no specific return on capital applied in the derivation of costs for these services as there is no specific significant capital invested in these activities. Fleet costs to transport and support the skilled labour are allocated where appropriate, and costs for information technology, rent and other items are incorporated in the overhead allowances in accordance with the approved CAM.

The costing methodology is detailed in the sections below.

4.1 Relevant Costs

The relevant costs for ANS comprise of costs for performing the different services, utilizing the relevant skilled resource in the organization to deliver the required service. As mentioned above, the resources allocated to service delivery are the most appropriate for the task at hand and recognise:

- > office located resources applied, for example, in design certification, and authorisation of ASP's, and
- > field based personnel with appropriate equipment / vehicles for connections or temporary supply for example.

Labour costs incorporate the approved statutory on-costs and the time required to travel to a premise to carry out the service. Other operating costs include the issue of stores or other materials (e.g. in training) where appropriate.

Overheads are applied to the base labour, fleet and materials costs in accordance with the approved CAM. A financing charge is also applied for the financing cost that represents the difference in time between when the costs are incurred by Essential Energy (predominantly labour related costs) and the collection date from the customer.

4.2 Calculation methodology

In calculating the prices for services, Essential Energy has adopted a straight forward approach to the identification of costs for the delivery of services, and the accumulation of those costs including overhead and financing to determine a charge which recovers only those costs for that service.

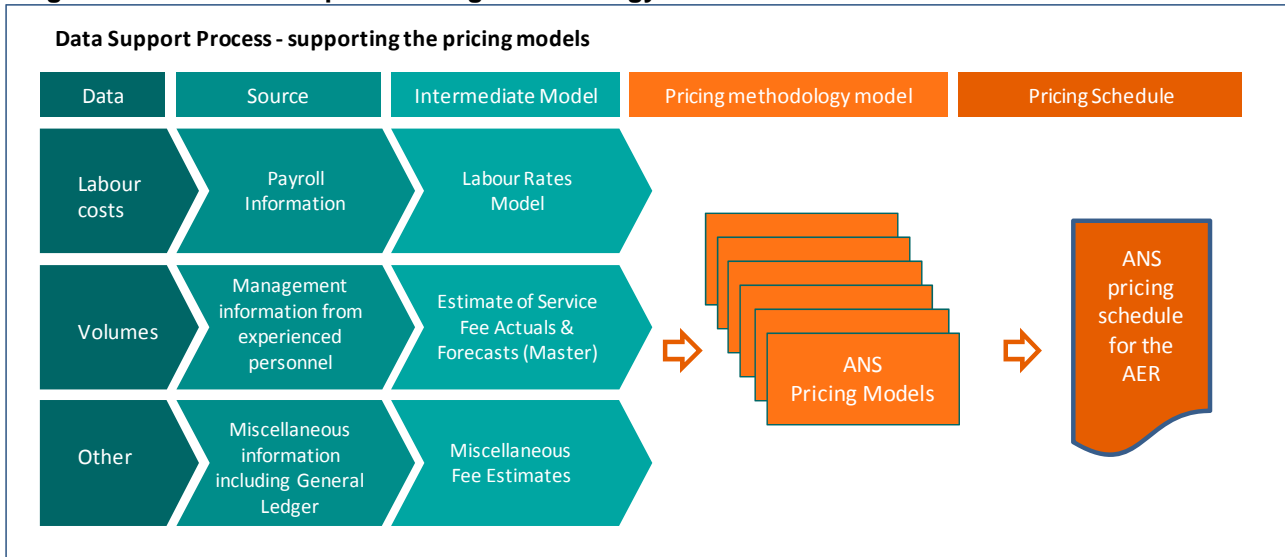
The process of developing the calculation methodology involved the preparation of a number of feeder models that supported the development of the ANS pricing models which will be presented to the AER. The process of collecting data from the business, and development of pricing models that would demonstrate the cost reflectivity of the ANS prices involved the collection of data from within the business.

The collection of data relating to historical costs for the provision of some services, the historic volumes and the allocation of some charges was not precise. When existing services were included as part of standard control service there was no driving need to capture the costs of providing the services specifically and work associated with them was simply including in the costs of standard control services. Some services were new to the ANS process and the charges have not necessarily recovered the full costs of the services in the past. As a result, work order system historical records are considered to be unreliable.

Because of this, Essential Energy has undertaken a process to collect information from management and field operational staff to develop the build-up of costs that reflect the efficient expenditure incurred in providing the relevant ANS.

In addition, where historical data has been used to support proposed prices by Essential Energy – this information has been compared to the management estimates developed internally. The process is set out below in the following diagram.

Diagram 1 – Overall ANS price setting methodology and data collection



4.3 The methodology for each ANS

For each ANS, the development of a unit price involved the collection of expenditures, and quantities of services delivered in order to establish the efficient costs for delivering those services. For each service, the following process was adopted.

- > For each relevant employee class an average hourly rate (\$2013/14) was calculated having regard to the base rate plus statutory on-costs and multiplied by the applicable hours to determine the direct unit cost for each task. The direct unit cost of all tasks relevant to the specific service was then totalled to derive the overall direct unit rate for each service.
- > The business units that provide the ancillary network service, provided estimates for the time taken to carry out the various tasks, and indicated the employee positions necessary to carry out those tasks having regard to the efficient deployment of the various skill sets across the business. This includes the time taken to travel to a premise to carry out the service. Due to Essential Energy's widespread geographical area travel times are a significant part of the time taken to perform those tasks undertaken at a premise.
- > The forecast unit rate was applied to the volumes forecast for the 2014 - 2019 regulatory period for this ancillary network service, to calculate an estimate for direct operating expenditure for this ancillary network service.
- > Where appropriate, a plant or fleet cost was applied to the estimated hours to apply a relevant cost for the plant and equipment or vehicles used in the delivery of the service. A standardised plant / fleet cost is applied across all the relevant service categories in this approach.
- > Additional costs for stores, materials and other costs are applied as appropriate to the task. This ensures cost reflectivity in accordance with the NER principles for pricing under an ACS methodology.
- > Overheads were applied to the direct costs based on our Cost Allocation Methodology (CAM).
- > Finally, a financing charge is included in the costs to allow for the timing difference of payments (predominantly labour) which are paid for as incurred, and the collection of receipts from customers which occurs after the delivery of the service and the collection of the invoiced amount. There is a degree of working capital which is funded by the organisation in this regard.

An example is set out below.

Example 1 – 16c Disconnection, Reconnection - Technical

Cost component	Hours	\$2013/14
Labour including on-costs and travel time (per hour) R4 field worker		70.83
Plant or fleet (per hour)		18.95
Total direct labour/plant/fleet cost per hour		89.78
Multiplied by total estimated standard service time	0.93 hours	
Total direct labour/plant/fleet costs per service		83.41
Add stores issued		0.46
Total direct costs per service		83.87
Add overheads at 41.97% of direct costs	41.67%	34.95
Add financing at 2.21% of total direct and indirect costs	2.21%	2.61
Total costs (and therefore supporting the recovered charge)		121.44

Costs may not add due to rounding

4.4 Revenue requirements for 2014 – 2019 period

In the sections above, we detailed the operating costs that are inputs into the calculation of the revenue we would require in the transitional year and subsequent four years for the provision of ANS. This revenue that we recover for these costs forms the basis for the price that we propose to charge customers who require these services. We have sought to develop pricing for ANS that meet the following principles:

- > Facilitates customer choice – this means providing cost reflective price signals to customers at their decision points. To the extent that customers can make these choices it is important that they be provided with these price signals, and provided early in their decision making process;
- > Cost reflective – to ensure customers make fully informed decisions we have sought to develop a cost reflective price. We have established our price robustly by reference to our current direct expenditure incurred in the provision of these tasks and our cost allocation methodology which has been approved by the AER;
- > Equitable – our approach seeks to reduce cross subsidisation between customers who receive standard control services and those that need alternative control services as we allocate costs accordingly;

We have also smoothed our forecast pricing requirements over the 2014-19 period to set prices in 2015/16 that will increase with CPI to replicate cost reflectivity within an administratively simple approach. This will provide customers with some certainty for the prices relating to ANS over the 2015-19 period.

4.5 ANS Prices

The transitional rules require us to provide prices for ANS as follows:

Table 2 – Setting of ANS prices

Price for service 2015/16	The transitional regulatory control period – 1 July 2014 to 30 June 2015	Subsequent regulatory control period – 1 July 2015 to 30 June 2019
Existing service provided under alternative control services	1 July 2013 prices increased by CPI	Cost reflective price for service
New service not previously provided under Alternative control services	n.a.	Cost reflective price for service

Essential Energy has therefore increased prices for existing services by CPI to apply for the year commencing 1 July 2014, and introduced a cost reflective price using this methodology for prices commencing 1 July 2015.

4.5.1 Annual ANS Prices

The tables in Attachment 8.10_Charges for Ancillary Network Services identify the cost reflective prices that we intend to charge from 1 July 2015. These charges recover the costs incurred in the provision of the services based on the forecast volumes that have been applied in the pricing methodology.

4.5.2 Compliance with control mechanism

The AER has decided to apply price caps on the charges of individual services to all alternative control services for the 2014-19 regulatory control period. The AER also set out its proposed formulae that give effect to the control mechanism. Essential Energy has adopted the AER's approach to the proposed formulae and considers that the demonstration of compliance with the control formulae for alternative control services will be done through the annual pricing proposal process, using the published lists of charges as the vehicle to demonstrate compliance. Clause 6.2.6(b) of the rules provides that, for alternative control services, the control mechanism must have a basis stated in the distribution determination and that the basis of control may use elements of Part C of the rules. Part C of the rules outlines the building block approach for standard control services.

In deriving charges for ancillary network services so that we can demonstrate compliance with the control mechanism, Essential Energy has adopted a cost build-up approach to the setting of these charges, an approach that is analogous to the building block approach prescribed for standard control services.

As noted in Chapter 4 above, Essential Energy considers that the pass through provisions in the rules should apply to alternative control services, and should form part of the basis of control to be determined by the AER. As we have utilised an approach to the setting of charges that is similar to the building block approach, we consider the costs of providing alternative control services can be adjusted to account for the cost impact of pass through events that have materialised (after having been subjected to the pass through assessment process by the AER under clause 6.61 of the rules).

4.6 Stakeholder engagement and Benchmarking

4.6.1 Stakeholder engagement

Stakeholder engagement is important for network businesses to understand stakeholder's needs and to provide two-way communication on the matters that relate to the delivery of services provided by an electricity network business. In Chapter two of our regulatory proposal we outline the process we have undertaken to engage with customers on a variety of issues. As the ANS charges payable by customers include electricity users connected to the Essential Energy Network and other customers such as developers and the building industry for example, our engagement will capture customer feedback that can incorporate these services within the broader context of electricity network services to customers within our service area.

4.6.2 Benchmarking

An independent review of the appropriateness of the proposed approaches, methodologies and resulting proposal for Ancillary Services charges for the 2014-19 regulatory period in comparison to the other two NSW DNSPs, was provided by KPMG. The resultant findings are included as an appendix to this proposal.



**Ausgrid, Essential Energy and Endeavour
Energy**

**Review of Networks NSW
Ancillary Networks Services
Proposals**

(Essential Energy)

May 2014

This report contains 24 pages

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*Ausgrid, Essential Energy and Endeavour Energy
Review of Networks NSW Ancillary Networks Services Proposals
Advisory
May 2014*

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Inherent Limitations

This report has been prepared as outlined in the Scope Section. The services provided in connection with this engagement comprise an advisory engagement, which is not subject to assurance or other standards issued by the Australian Auditing and Assurance Standards Board and, consequently no opinions or conclusions intended to convey assurance have been expressed.

No warranty of completeness, accuracy or reliability is given in relation to the statements and representations made by, and the information and documentation provided by the management and personnel / stakeholders from, Ausgrid, Essential Energy and Endeavour Energy consulted as part of the process.

KPMG have indicated within this report the sources of the information provided. We have not sought to independently verify those sources unless otherwise noted within the report.

KPMG is under no obligation in any circumstance to update this report, in either oral or written form, for events occurring after the report has been issued in final form.

The findings in this report have been formed on the above basis.

Third Party Reliance

This report is solely for the purpose set out in the Scope Section and for Ausgrid's, Essential Energy's and Endeavour Energy's information, and is not to be used for any other purpose or distributed to any other party without KPMG's prior written consent.

This report has been prepared at the request of Ausgrid, Essential Energy and Endeavour Energy in accordance with the terms of KPMG's engagement letter dated 11 March 2014. Other than our responsibility to Ausgrid, Essential Energy and Endeavour Energy, neither KPMG nor any member or employee of KPMG undertakes responsibility arising in any way from reliance placed by a third party on this report. Any reliance placed is that party's sole responsibility.

1 Summary

KPMG has been engaged to conduct a review of the methodologies applied to the development of proposed prices for Ancillary Network Services (ANS) prepared by Essential Energy (Essential), having regard to the methodologies employed by other NSW network businesses; Endeavour Energy (Endeavour) and Ausgrid.

These prices are required to be developed in accordance with the Australian Energy Regulator's (AER) Framework and Approach Paper¹ as part of changes to electricity network regulation in the National Electricity Market.

1.1 Scope

The scope of the review was to examine the approach employed by Essential for the development of ANS prices, and report on similarities and differences to those used by Ausgrid and Endeavour.

In particular KPMG was asked to:

- 1 Review Essential's proposed pricing methodologies for calculating the ancillary network services prices, having regard for the methodologies applied by Endeavour and Ausgrid for their equivalent services;
- 2 Review Essential's proposed approach to the allocation of overhead costs built into their ancillary network services methodologies, having regard for the approaches that has been applied by Endeavour and Ausgrid for their equivalent services; and
- 3 Assess the suitability of any differences between the three organisations' proposed pricing methodologies and overhead allocation approaches, given the breakdown of the information historically captured and available.

1.2 Approach

KPMG's approach consisted of:

- an examination of the relevant guidance documents issued by the AER, including the Regulatory Information Notices (RINs), and supporting documentation such as the Cost Allocation Methodology, and
- reviewing the detailed application of the pricing methodology contained within the pricing models developed by Essential.

¹ Australian Energy Regulator
Stage 1 Framework and approach paper
Ausgrid, Endeavour Energy and Essential Energy
Transitional regulatory control period 1 July 2014 to 30 June 2015
Subsequent regulatory control period 1 July 2015 to 30 June 2019

1.3 The results

The scope set out three objectives. Each one was addressed and reported in the body of this report.

- In respect to the first part of the scope: we reviewed Essential's proposed pricing methodologies for calculating the ANS prices, and the methodologies applied by Endeavour and Ausgrid for their equivalent services. In particular the Essential files examined are set out in section 4, where we have documented the format and content of the workbooks, and made comments on inputs and methodology statements incorporated into their documentation.
- In respect to the second part of the scope: we reviewed Essential's proposed approach to the allocation of overhead costs built into their ANS pricing methodology workbooks having regard for the approaches that have been applied by Endeavour and Ausgrid for their equivalent services. The allocation of overheads was consistent with the CAM that has been submitted to the AER, and incorporates a consistent methodology for allocating overheads to the direct costs as part of the build-up of an applied labour rate used to set a cost reflective price. The use of the overhead allocation methodologies is discussed in:
 - Section 4.5– Methodology Statements documented in the approach; and
 - Section 5.1 – Methodology application (through observation of the calculations).
- In respect to the third part of the scope: we assessed the suitability of any differences between the three businesses proposed pricing methodologies and overhead allocation approaches, given the breakdown of the information historically captured and available to the calculation process. Our analysis identified that:
 - The methodologies applied were materially identical in that they derived a supported labour rate that would deliver the service, and constructed a loaded labour rate including overheads, to apply to the resourcing required to deliver the task based on the experience within the organisation to deliver that task.
 - The methodologies developed prices that would recover only those loaded costs.
 - Essential's implementation of the methodology demonstrated that:
 - ❖ its calculations were based on the 2013/14 base year labour rate as noted in its workbooks; and
 - ❖ its approach was compliant with the RIN.

This is documented in Section 5 below.

In our assessment of the methodologies applied to develop the ANS prices, we identified four tests which are set out in Section 3.4. These tests were designed to evaluate the methodologies against the following principles:

- Test 1 – Does the methodology limit external cross-subsidisation?
- Test 2 – Does the methodology limit internal cross-subsidisation?
- Test 3 – Does the methodology provide reasonable aggregate recovery?
- Test 4 – Does the methodology document reasonable support for price components?

In Essential's case, its methodologies pass the first three tests, but Essential's documentation is not as advanced as Endeavour's due to a lack of historical information. This is summarised in Section 6 (with the support for these conclusions discussed in Sections 4 and 5 of this report).

2 Scope and purpose

2.1 Background

The purpose of the review was to examine the methodologies applied to the development of proposed prices for ANS prepared by Essential Energy – including by reference to the prices proposed by Endeavour and Ausgrid.

These prices are required to be developed in accordance with the AER's Framework and Approach Paper.

Ancillary Network Services is the term used by the AER to describe classes of services provided by NSW distribution businesses to their customer base that are non-routine and are used by individual customers on an 'as needs' basis. From 1 July 2014 there will be up to 30 service groups in general that belong to the class of Ancillary Network Services.

2.2 Scope

KPMG was asked to conduct a review of the ANS pricing methodology following changes introduced by the AER.

The scope of the review was to examine the approach employed by Essential for the development of ANS prices, and report on similarities and differences to those used by Ausgrid and Endeavour.

This was to be conducted on the methodologies presented in the individual model calculations that have been prepared for each of the service groups defined in the Stage 1 Framework and Approach paper. The AER list of services is attached as Appendix A.

In particular KPMG was asked to:

- Review Essential's proposed pricing methodologies for calculating the ancillary network services prices, having regard for the methodologies applied by Endeavour and Ausgrid for their equivalent services;
- Review Essential's proposed approach to the allocation of overhead costs built into their ancillary network services methodologies, having regard for the approaches that have been applied by Endeavour and Ausgrid for their equivalent services; and
- Assess the suitability of any differences between the three organisations' proposed pricing methodologies and overhead allocation approaches, given the breakdown of the information historically captured and available.

For clarity, we confirm that we have not examined, and do not provide any view on, the accuracy of data used or the appropriateness of the levels of the prices being proposed by the three organisations for their ancillary network services.

2.3 Purpose

The purpose of this review is to inform Essential on the consistency of the pricing methodologies applied to the ANS with regard to AER Stage 1 Framework and Approach paper and other principles of good pricing including the approach used in the allocation of overheads.

We also understand that this report may be provided to the AER, to inform the AER of the findings of this review, in accordance with Essential's regulatory proposals to the AER.

2.4 Format of this report

This report is structured as follows:

- Section 3 describes the framework established by the AER for the development of ANS prices;
- Section 4 sets out the approach adopted by Essential;
- Section 5 looks at how Essential's methodology compares with those used by Endeavour and Ausgrid; and
- Section 6 sets out the conclusions.

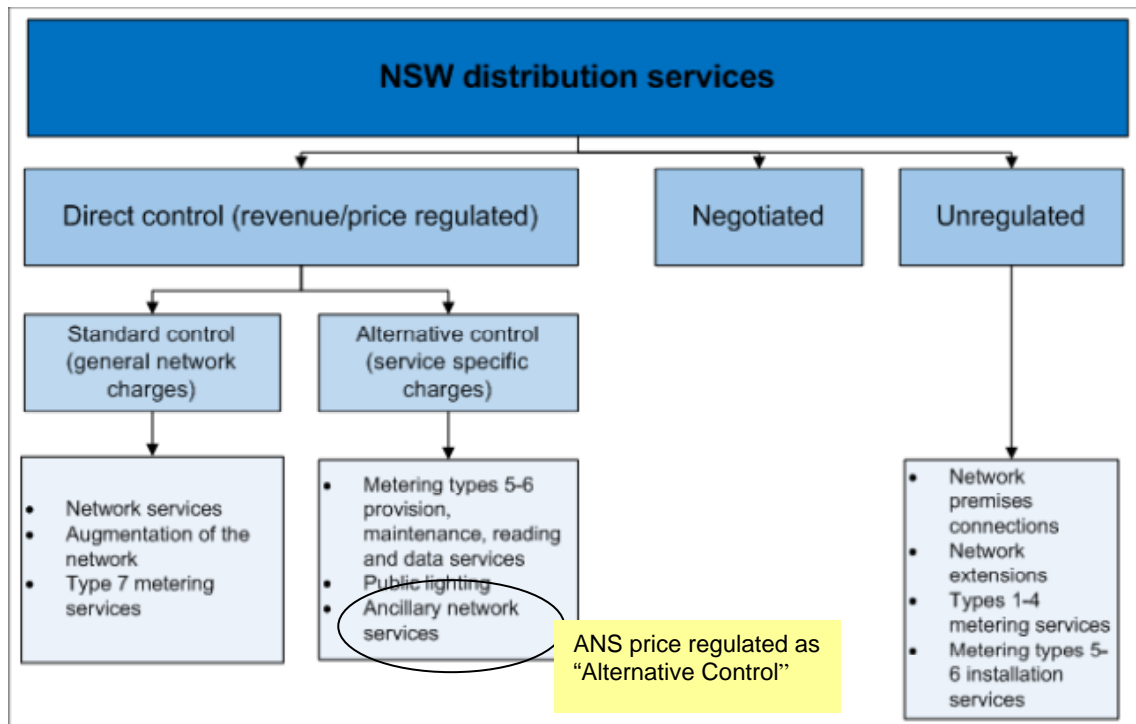
3 Framework for developing ANS prices

3.1 AER requirements

The AER’s Stage 1 Framework and Approach paper establishes the overall context for pricing electricity distribution services. This paper was issued in March 2013, and sets out the approach for the 2014/15 year (the transitional year) and the subsequent regulatory control period commencing with the 2015/16 year. The paper is issued pursuant to powers granted the AER by the National Electricity Law and National Electricity Rules.

Figure 3.1 from that paper summarises the AER’s proposed classification of services and identifies the need for ANS to be priced as alternative control services:

Figure 3.1: AER’s proposed classification of NSW distribution services



Source – AER Stage 1 Framework and Approach Paper – page 9

The AER goes on to describe ANS as follows:

Ancillary network services, which include proposed additional ancillary network services and incidental services, involve work on, or in relation to, parts of the NSW distributor’s distribution network. Therefore, only the distributor can undertake these services.

We consider that, similar to network services, there is a regulatory barrier preventing any party other than the NSW distributors providing ancillary network services. Because of this monopoly position, customers have limited negotiating power in determining the price and other terms and conditions on which the distributors provide these services. Furthermore, the scale of resources available to the NSW distributors is also likely to prevent alternative providers from competitively providing ancillary network services. These factors contribute

to the view that, like network services, the NSW distributors possess significant market power in providing ancillary network services.²

In the past various 'monopoly and miscellaneous services' that will in future be part of ANS have been subject to a form of direct price control. Other services have been part of general network charges, but are now separately priced as ANS as a response to the National Energy Customer Framework's requirements. The full range of services to be classified as ANS in future is set out in Appendix D³ of the Stage 1 Framework and Approach paper and included in Appendix A to this report.

The AER go on to elect a price cap approach as the control mechanism for ANS. The AER considered the following factors:

- influence on the potential for competition;
- administration costs;
- pre-existing arrangements;
- consistency with other jurisdictions; and
- cost reflectivity.

It described its main consideration as being cost reflective pricing. The AER goes on to state that they *consider this benefit outweighs any detriment from increased administration costs⁴*.

The AER then describes a price cap formula in the basic form:

$$p_i^t = p_i^{t-1} (1 + CPI_t) (1 + X_i^t) + A_i^t$$

Where X is able to be set on a service by service basis and A is an adjustment factor which is described as *likely to include, but not limited to adjustments for residual charges when customers choose to replace assets before the end of their economic life*.

In January 2014, the AER published a Stage 2 Framework and Approach⁵ paper. While it dealt substantially with other issues, comment was made on the Alternative Control Services (including ANS) prices that would apply in the 2014-15 year. This reference is important only in the sense that it refers to a possible 'true up' being required where previous prices increased by CPI do not produce the revenue that would be expected if a deflated 2015-16 price were used. The AER reserved its position on this matter.

In addition, Essential was issued with a RIN in March 2014. The RIN defines the way in which the AER requires information to be presented to it in relation to the entirety of the 2014–2019 regulatory period. In particular, section 13 of Schedule 1 requires:

13. FEE BASED AND QUOTED ALTERNATIVE CONTROL SERVICES

13.1 *Provide a description of each fee based and quoted service, explaining the purpose of the service and list the activities which comprise each service. The list of fee*

² Page 33

³ Page 81-84

⁴ Page 57

⁵ Stage 2 Framework and approach
Ausgrid, Endeavour Energy and Essential Energy

based and quoted services should be consistent with those services listed in Essential Energy's annual tariff proposals.

- (a) Specify if the charges are for fee based and/or quoted alternative control services;*
- (b) Explain the reasons for the different charge with reference to the costs incurred;*
- (c) Explain the method used to set the different charge; and*
- (d) Provide the calculations underpinning the different charge.*

13.2 Identify the tasks involved in providing the service in regulatory templates 4.3 and 4.4

- (a) Map the class of labour required to provide the service listed in regulatory templates 4.3 and 4..*
- (b) The number of workers required to undertake the task and deliver the service*
- (c) The average time required to complete the task and deliver the service*

13.3 If materials are required to provide the service, specify each material category

13.4 Provide all current and proposed charges for each fee based and quoted alternative control service in the current and forthcoming regulatory control periods.

Section 19 of Appendix E lists principles and requirements and reads as follows:

19. FEE BASED AND QUOTED ALTERNATIVE CONTROL SERVICES

19.1 Essential Energy must ensure that the data provided for fee-based and quoted services reconciles to internal planning models used in generating Essential Energy's proposed revenue requirements.

19.2 In regulatory templates 4.3 and 4.4, Endeavor Energy must list all the fee-based and quoted services that were listed in the annual tariff proposal of each relevant year.

19.3 In the basis of preparation, Essential Energy must provide a description of each fee-based and quoted service listed in regulatory templates 4.3 and 4.4. In each services' description, Essential Energy must explain the purpose of each service and detail the activities which comprise each service.

Finally, Essential was required by the AER to prepare and submit for approval a Cost Allocation Method (CAM) consistent with the AER's Cost Allocation Guidelines. We have seen a copy of this document dated March 2014 and understand that this was approved by the AER on 9 May 2014.

This CAM (and the AER Guidelines) are based on the following core principles:

- costs/assets that are directly attributable to a service should be allocated directly to that service;
- costs/assets that are shared between services should be allocated to those services on a causal basis; and
- costs/assets that are shared between services but a causal link cannot be applied should be allocated on a reasonable, defensible and non-distortionary basis.

Fundamental also is the expectation that costs applicable to price derivation ought be allocated (and recovered) once.

The Essential CAM contains various commitments to comply, but also details the system environment within which compliance will occur.

3.2 Significance of ANS to the NSW distribution businesses

The NSW distribution businesses provide a network that supplies electricity to the majority of the NSW population. The main business is the provision of network services defined and priced as Standard Control Services.

The following table sets out the comparison of the revenues identified in the Transitional Pricing Proposals that demonstrate the relative size of Standard Control Services and Alternative Control services (which includes ANS).

Table 1: Relative size of Alternative Control Services

Revenue base in millions 2014/15 projected	Standard Control	Alternative Control	Unregulated Unbundled
Ausgrid ⁶	\$2,170m 96.0%	\$90m 4.0%	- -
Essential ⁷	\$1,293m 94.9%	\$70m 5.1%	\$1m -
Endeavour ⁸	\$988m 94.0%	\$63m 6.0%	- -

We have been informed that the level of revenue currently received in respect of ANS is perhaps less than half the costs incurred in providing those services. This contention is supported by the extent to which proposed fees are, in the main, very much higher than current fees for the same services. At present, this revenue is, at least partially, recovered through general network fees.

3.3 Significance of ANS to customers

It is also important to consider the impact of ANS pricing on customers.

ANS are consumed by customers as they make necessary but non-routine demands on the distribution system. Because ANS include very limited charges related to assets (some vehicle expense, office equipment, etc), consumer interest would appear to be served if the charges:

- reflect costs; and

⁶ Source – Page 19 of the Ausgrid Transition regulatory proposal
<http://www.aer.gov.au/sites/default/files/Ausgrid%20-%20Transitional%20regulatory%20proposal%20-%2031%20January%202014.PDF> (ANS excludes street lighting)

⁷ Source – Page 26 of the Essential Energy Transition regulatory proposal
<http://www.essentialenergy.com.au/asset/cms/pdf/submission/EssentialEnergyTransitionalProposal.pdf>

⁸ Source – Page 24 of the Endeavour Energy Transition regulatory proposal
<http://www.endeavourenergy.com.au/wps/wcm/connect/e3d7108042c1c9f28582c564e4d60193/Endeavour+Energy+Transitional+Regulatory+Proposal+31+January+2014.pdf?MOD=AJPERES>

- are not an impediment to use of an electricity service.

Reviewing the scope of services listed it would appear that those likely to be paid by householders in an existing dwelling are:

- limited - in the sense that most customers will incur these charges infrequently; and
- modest – in that they will usually be less than 10% of the consumer’s likely annual electricity bill or an even smaller proportion of the value created by safe / secure access to the electricity system.

In other situations these charges will be paid by property owners / developers arranging for electricity supply to new sites. Again the proposed costs appear to be modest in relation to the value that safe / secure access to an electricity system provides.

There is a further element to consumer interest in prices that comes into play when there is a substantial change from that which has applied in the past. Because the proposed prices are, in many cases, much higher than they have been in the past, we would expect consumer interest / concern to be high.

In such circumstances the expectation of the AER will be that the proposed changes to prices are properly supported. Generally this will mean that the businesses will need to present information in support of their proposals that is transparent and convincing.

3.4 Methodology tests

The AER has explicitly set its main consideration as cost reflective pricing. Applying the normal meaning of ‘cost reflective’ we would expect that the AER is concerned to ensure that the customers charged for ANS services:

- do not unduly cross-subsidise, or are not themselves cross-subsidised by, the “Standard Control” customers;
- do not unduly cross subsidise, or are themselves cross-subsidised by other ANS prices; and
- pay an amount that recovers, but does not unduly over-recover the aggregate cost of providing ANS.

In the remainder of this report we refer to these 3 issues as follows:

- Test 1 – external cross-subsidisation;
- Test 2 – internal cross-subsidisation; and
- Test 3 – reasonable aggregate recovery.

Having considered the proposed level of ANS prices against those that currently apply and being aware of the current level of public interest in electricity prices, we believe a further test becomes relevant – related to the level of support there is for the prices proposed. It seems reasonable to expect that, if the components of a proposed price are not well supported, the AER may be encouraged to not approve prices. We therefore have added a further test:

- Test 4 – reasonable support for price components.

4 Essential Energy’s ANS pricing approach

4.1 Material reviewed

Essential has prepared a series of Excel Workbooks that document the derivation of the various ANS prices. The Workbooks we have considered in developing this report are listed below:

Workbook names
Fee construction sheets
01 Design Fees for ANS.xlsx
02 - Inspections & CW Related Fees for ANS.xlsx
03 ASP Fees for ANS.xlsx
04 Miscellaneous Fees for ANS.xlsx
05 Connection Fees for ANS.xlsx
06 MIMO reads Fees for ANS.xlsx
07 Disconnection - Reconnection Fees for ANS.xlsx
08 Office Fees for ANS.xlsx
09 Field Services Fees for ANS.xlsx
Feeder models
EssentialLabourRatesModelV3.2
Estimate of Service Fee Actuals & Forecasts (Master) V1.0.xlsx
Miscellaneous Fee Estimates.xlsx

4.2 Format and content of workbooks

Each Fee Construction workbook has a common format as follows:

Spreadsheet section	Tabs within the section
Summary	Summary of results for services within the group
Input sheets	Global Inputs Service Description Service History Service Projections
Outputs sheets	Fee Construction
Summary	Summary

The layout of the Workbooks is logical and easy to follow. RIN requirements are met as follows:

RIN requirements	Location
Service description	Input on Service Description tab. Also shown on Summary sheet.
Purpose	Part of Service Description.
List of activities	Part of Service Description.

RIN requirements	Location
Fee based or quoted	Shown on Service Projections tab and on Summary sheet.
Methodology used	Input on Service Description tab. Also shown on Summary sheet.
Calculations	Intermediate calculations are on Input tabs and the fee calculation is summarised on the Fee Breakdown tab.

4.3 Inputs

While we have not checked every cell, it appears that the only inputs to the model are on tabs in the Input Sheets section of each Workbook. The cells into which inputs are placed are identifiable – and each input has the provision for a description of the source of the information that is designed to capture sufficient source identification to understand where it has come from and where one might go for further explanation if it were required.

Loaded labour rates have been calculated in a feeder model called EssentialLabourRatesModelV3.2. The outputs of that model are inputs on the Global Inputs tab of all Fee Construction models.

Historical costs and volumes are initially collected in the feeder models titled Estimate of Service Fee Actuals & Forecasts (Master) V1.0.xlsx and Miscellaneous Fee Estimates.xlsx. The outputs of those models are inputs on the Service History and Service Projections tabs.

4.4 Outputs

The Fee Breakdown tab includes a breakdown of each fee – and links to input cells on tabs in the Input Sheets section of the model.

4.5 Methodology

In accordance with our scope, our assessment relates mainly to methodology – which is summarised on the Service Description tab of the workbooks. All Fee Construction workbooks used the same methodology description as follows:

In order to derive unit rates for this ancillary network service, the following methodology was used:

- *The business units that provide this ancillary network service provided estimates for the amount of time taken to carry out the various tasks and which employee positions carried out these tasks.*
- *For each employee position an average hourly rate (\$2013/14) was calculated and multiplied by the applicable hours to determine the unit cost for each task. The unit cost of all tasks were then totalled to derive the overall unit rate for this service.*
- *The forecast unit rate was applied to the volumes forecast for the 2014 - 2019 regulatory period for this ancillary network service to calculate an estimate for direct operating expenditure for this ancillary network service.*

- *Overheads were applied to the direct costs based on our Cost Allocation Methodology (CAM).*

Source: 'Service Description' worksheet tab within the "01 Design Fees 1405.xlsx" workbook.

Of particular importance is the method by which overhead costs are recovered. We understand that at the time of preparing this report, the CAM may not yet be approved by the AER, but we understand that this matter is progressing between the AER and Essential.

In any case, the method used for the proposed prices involves recovering the network and corporate overheads considered to be applicable to ANS via a simple (and consistent) loading on each dollar of direct labour cost.

In the next section, we compare the approach adopted by Essential to that used by Endeavour and Ausgrid. In the final section, we provide our assessment of the Essential methodology against the four tests set out at the end of Section 3.

5 Comparison to Endeavour Energy and Ausgrid ANS pricing approaches

5.1 Methodology

The methodological approaches adopted by all three businesses are materially identical. That is, they involve:

- 1 Identification of the activities and resources involved.
- 2 Construction of a loaded labour rate.
- 3 For services that are proposed to be ‘fee based’, derivation of an amount of hours that will typically apply.
- 4 For services that are proposed to be ‘quoted’, identification of the loaded labour rate(s) that will apply.

Given the AER’s stated focus on ‘cost reflectivity’, the general pricing theory would require:

- recovery of direct costs from the parties causing such costs; and
- recovery of indirect costs on a basis that does not unduly distort the pattern of consumption of the service being priced – or any other service.

The methodology used by all three businesses would appear to ‘pass’ the first arm of this requirement in that the majority of cost might be identified as direct labour – and the methodologies all involve direct attribution of labour cost to the relevant service.

Ausgrid and Endeavour adopt the same approach to overhead recovery as Essential – that is, they load an equal amount of network and corporate overheads onto each direct labour hour. There is no reason obvious to us why this approach should not pass the second arm of the requirement and be non-distortionary.

Our conclusion therefore is that, at the ‘theory level’, the methodologies are materially the same and, provided they are properly implemented, they should result in prices that pass the first three tests listed at the base of Section 3. That is:

- Test 1 – external cross-subsidisation;
- Test 2 – internal cross-subsidisation; and
- Test 3 – reasonable aggregate recovery.

5.2 Implementation

Where the approaches appear to us to diverge is in the implementation.

Each business has applied the same methodology, but there are substantial differences in the level of support provided for each step. This is summarised in Table 2 below.

Table 2: Comparison of methodologies

Element	Implementation differences
Identification of activities and resources	<p>Essential</p> <p>Essential’s Workbooks are logically structured and include lists of activities and estimates of resources deployed that are, in almost all circumstances, based on management estimates. The feeder workbook Estimate of Service Fee Actuals & Forecasts (Master) V1.0.xlsx sets up a solid framework for collecting relevant information, but in most cases, limited historical information is provided.</p> <p>There is some historical data drawn from financial systems, but relatively little drawn from engineering systems. Essential’s Workbooks were in development at the time of writing this report and we expect them to include additional commentary on the derivation of the estimates.</p>
	<p>Endeavour</p> <p>Endeavour’s Workbooks include more detailed descriptions of each service – and, more particularly, identify the resources that have been applied historically. These details are drawn from a variety of engineering and financial sources.</p>
	<p>Ausgrid</p> <p>Ausgrid’s Workbooks include less detailed information on the activities and resources and, more particularly in the form provided for this review, do not include any specific commentary on sources that would allow an assessment of the validity of the historical records presented.</p>
Construction of a loaded labour rate	<p>Essential</p> <p>Essential provide payroll sourced data for 5 staff classifications. The loadings applied are fully described.</p>
	<p>Endeavour</p> <p>Endeavour provide information from payroll records on (in most cases) the specific staff involved in delivery of each service. The loadings are also fully described.</p>
	<p>Ausgrid</p> <p>Ausgrid provide payroll data for 5 staff classifications. The loadings applied are fully described.</p>
Derivation of standard hours for fee based services	<p>Essential</p> <p>Essential proposed standard hours that are based on management estimates. Essential consider that their historical records are not adequate to offer any additional support.</p> <p>Because Endeavour has supported their estimates of hours more comprehensively, there is an opportunity for Essential to ‘borrow’ support for its proposed standard hours. In most cases, the “Essential” proposed hours for similar (or identical) services are reasonably close to those applied by Endeavour although the methodology documentation does not make this explicit comparison.</p>
	<p>Endeavour</p> <p>Endeavour provide reasonably detailed information on historical volumes relevant to the setting of ‘standard hours’ for new prices. Where management judgement has varied anything from that which has applied historically, it is generally well described in the source notes.</p>
	<p>Ausgrid</p>

Element	Implementation differences
	Ausgrid proposed standard hours are based on management estimates. Ausgrid have described the grade of technician applied and the average time in hours to complete that task.

Essential have advised us that information of the type necessary has either not previously been collected – or has been collected, but is not reliable because, in the past, it has not been considered particularly relevant. Essential therefore decided that the best source of information for price development were estimates made by the management and staff most directly involved with the provision of the service.

By comparison with Endeavour, Essential’s implementation of its ANS price setting methodology is:

- less well supported by relevant historical data – particularly from engineering systems; and
- less well described in the source notes than Endeavour.

Both Essential and Endeavour appear to be compliant with the RIN in the sense that each required element is listed.

By comparison with Ausgrid, Essential’s implementation of its ANS price setting methodology is better set out and thereby better able to be assessed by management or the AER.

6 Assessment and conclusions

6.1 Assessment against tests

At the end of Section 3, we listed four tests we thought appropriate to a methodology assessment for ANS pricing. Our consideration in relation to each test is as follows:

- Test 1 – external cross-subsidisation

By design, the Essential methodology should limit cross subsidisation between Standard Control Services and ANS. The Essential CAM also includes specific language relevant to this concern. The form of the RIN is such that this captures information on costs across the business that should reduce the risk of this type of cross subsidy. Finally, it is the intention of the form and content of the Workbooks to evidence Essential's proper implementation of its methodology which will allow each party that reviews the pricing proposal to assess for themselves the reasonableness of the judgements made.

- Test 2 – internal cross-subsidisation

By design, the methodology should act to limit cross subsidisation between ANS. The form of the Workbooks evidence implementation in an open and transparent approach and allow each reviewer to assess for themselves the reasonableness of the judgements made.

- Test 3 – reasonable aggregate recovery

The following elements of the methodology are protective of aggregate under or over recovery:

- the method of calculating the labour rate (specific staff identification);
- the requirements of the CAM;
- the requirements of the RIN; and
- the A factor in the price control formulae.

The format of the Workbooks sets up a capacity to identify and analyse under or over recovery in future.

- Test 4 – reasonable support for price components.

The most challenging part of the ANS price setting process for all parties is going to be the degree of change from current prices. The general environment for electricity prices is such that one would expect any price increases will need to be very well supported.

While information supporting loaded labour rates appears to be adequate, the proposed standard hours required are not well supported by historical information.

The Essential Workbooks are, however, in a format which readily allows for the capture of additional supporting documentation.

We note that the RIN explicitly allows for the provision of information on what it terms '*transitional issues (expressly identified in the Rules or otherwise)*'. It seems possible the informational challenges Essential is dealing with could be covered by such a provision.

This would however, require documentation of the circumstances that have given rise to such challenges.

We also note that it would appear that proposed standard hours for a number of services are quite similar between Essential, Endeavour and Ausgrid. Endeavour's more comprehensive documentation for its proposed hours offers an additional level of support for Essential proposed prices that has not been accessed to date.

6.2 Conclusion

The ANS pricing Workbooks provided to us by Essential, provide evidence that:

- Essential has developed a methodology that is consistent with an objective of cost reflective pricing; and
- except for the derivation of proposed standard hours for fixed fees (as discussed in the sections above), Essential has implemented the methodology appropriately.

Appendix A: AER Framework and Approach Paper – list of Alternative Control Services

Service group/Activities included in service group	Further description (if any)	AER's proposed classification 2014–19	Current classification 2009–14
AER Service group— Ancillary network services			
Design related services	Provision of design information, design certification and design rechecking services in relation to connection and relocation works provided contestably	Alternative control	Standard control
ASP inspection services	Inspection and re-inspection of contestable connection and relocation works performed by Accredited Service Providers (ASPs)	Alternative control	Standard control
Reinspection of installation work in relation to customer assets	Reinspection by a distributor of private electrical wiring work undertaken by an electrical contractor, required where the first inspection revealed defective work.	Alternative control	Standard control
Contestable substation commissioning	Includes Contestable substation commissioning (complex) and Contestable substation commissioning (basic). Involves the process of connecting the substation to the network. Complex involves kiosk and chamber substations that may involve protection settings. Basic is generally pole mounted substations.	Alternative control	Standard control
Access permits	The provision of an access permit by a distributor to a person authorised to work on or near distribution systems including high voltage.	Alternative control	Standard control
Clearance to work	The provision of a clearance to work by a distributor to a person authorised to work on or near the system generally at a low voltage.	Alternative control	Standard control
Access (standby person)		Alternative control	Standard control
Notices of arrangement	Work of an administrative nature performed by a distributor where a local council requires evidence in writing from the distributor that all necessary arrangements have been made to supply electricity to a development. This may include receiving and checking linen plans and 88 B instruments, copying linen plans, checking and recording easement details, preparing files for conveyancing officers, liaising with developers if errors or charges are required, checking and receiving duct declarations and any amended linen plans and 88B instruments approved by a conveyancing officer and preparing notifications of arrangement.	Alternative control	Standard control
Authorisation of ASPs	Annual authorisation of individual employees and sub-contractors of ASPs and additional authorisations at request of ASP. Authorisation excludes training costs.	Alternative control	Standard control

Service group/Activities included in service group	Further description (if any)	AER's proposed classification 2014–19	Current classification 2009–14
Administration services relating to work performed by ASPs, including processing work		Alternative control	Standard control
Conveyancing information	Supply of conveyancing information – desk inquiry; Supply of conveyancing information – field visit	Alternative control	Standard control
Site establishment fee services	Site establishment services, including issuing of meters and liaising with the AEMO or market participants for the purpose of establishing NMIs in market systems, for new premises or for any existing premises for which AEMO requires a new NMI.	Alternative control	Standard control
Customer interface coordination for contestable works		Alternative control	Standard control
Preliminary enquiry service	For services provided to connection applicants making a preliminary enquiry requiring site-specific or written response	Alternative control	Standard control
Connection offer service (basic or standard)	For services provided by distributors in assessing the applicant's application and making a basic or standard connection offer	Alternative control	Standard control
Reconnections/Disconnections	Disconnection or reconnection visits (acceptable payment received); Disconnections or reconnections at the meter box (technical/hard disconnect); Disconnections or reconnections at the meter box (non-technical/soft disconnect); Disconnections or reconnections at the pole top/pillar box; Disconnections or reconnections outside of business hours.	Alternative control	Standard control
Ancillary metering services	For example, special meter reading for types 5 and 6 meters; testing for type 5 and 6 meters; franchise CT meter install; customer requested meter accuracy testing; types 5–7 non-standard metering data services; replacement or removal of a type 5 or 6 meter instigated by a customer switching to a non-type 5 or 6 meter that is not covered by any other fee.	Alternative control	Standard control
Off-peak conversion		Alternative control	Standard control

Service group/Activities included in service group	Further description (if any)	AER's proposed classification 2014–19	Current classification 2009–14
Rectification works	Includes rectification of illegal connections, provision of service crew/additional crew, fitting of tiger tails, high load escorts	Alternative control	Standard control
Connection/relocation process facilitation		Alternative control	Standard control
Services to supply and connect temporary supply to one or more customers	Including equipment and related costs) in relation to planned access permits	Alternative control	Standard control
Carrying out planning studies and analysis relating to distribution (including sub-transmission and dual function assets) connection applications		Alternative control	Standard control
Services involved in obtaining deeds of agreement in relation to property rights associated with contestable connection works		Alternative control	Standard control
Investigation, review and implementation of remedial actions associated with ASPs' connection work		Alternative control	Standard control
Network tariff change request	When a customer or retailer requests an alteration to an existing network tariff (for example, a change from an Inclining Block Tariff to a Time of Use tariff), the NSW distributors conduct tariff and load analysis to determine whether the customer meets the relevant tariff criteria. The NSW distributors also process changes in their IT systems to reflect the tariff change.	Alternative control	Standard control
Recovery of debt collection costs – dishonoured transactions	B2B service orders from retailers to obtain a final read for customer move-outs or to obtain a start read where property has been vacant	Alternative control	Standard control
Services provided in relation to a Retailer of Last Resort (ROLR) event	The NSW distributors may be required to perform a number of services as a distributor when a ROLR event occurs. These include: Preparing lists of affected sites, and reconciling data with AEMO listings; handling in-flight transfers; identifying open service orders raised by the failed retailer and determining actions to be taken in relation to those service orders; arranging estimate reads for the date	Alternative control	Standard control

Service group/Activities included in service group	Further description (if any)	AER's proposed classification 2014–19	Current classification 2009–14
	of the ROLR event and providing data for final NUOS bills in relation to affected customers; preparing final invoices for NUOS and miscellaneous charges for affected customers; preparing final debt statements; extracting customer data, providing it to the ROLR and handling subsequent enquiries; handling adjustments that arise from the use of estimate reads; assisting the retailer with the provision of network tariffs to be applied and the customer move in process; administration of any 'ROLR cost recovery scheme distributor payment determination'.		
Attendance at customers' premises to perform a statutory right where access is prevented.		Alternative control	Standard control
Vacant property reconnect/disconnect	Includes customer request for ad-hoc reconnections/disconnections for regular but short periods of time, for example, holiday homes.	Alternative control	Standard control
Move in move out meter reads	Includes customer request for ad-hoc reconnections/disconnections for regular but short periods of time, for example holiday homes.	Alternative control	Standard control
AER Service group— Public lighting services			
Provision, construction and maintenance of public lighting and emerging public lighting technology		Alternative control	Alternative control

Source: Pages 81 to 84 of the Stage 1 Framework and Approach paper⁹

⁹ AER paper <http://www.aer.gov.au/sites/default/files/AER%20-%20Stage%201%20Framework%20and%20Approach%20-%20NSW%20distributors%20-%20March%202013.pdf>