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## **Submission to Essential Services Commission**

# **Advanced Metering Infrastructure Review Consultation Paper: Revised Framework and Approach**

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**Jemena Electricity Networks (Vic) Limited**

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**29 December 2008**

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## 1 Introduction

This submission is made jointly by Jemena Electricity Networks (JEN) and United Energy Distribution (UED). JEN and UED (the companies) welcome this opportunity to comment on the Essential Services Commission's (ESC) proposed revised framework and approach for the advanced metering infrastructure review.

### 1.1 Reasons for Joint Submission

The companies have decided to make a joint submission on this occasion, because the ESC's consultation paper (Paper) seeks comments on the overarching methods and approaches to be used when assessing the budget (and resulting prices) of the joint Advanced Interval Metering Roll Out (AIMRO) Program (joint program) established by the companies.

The companies' electricity distribution networks have differing characteristics and there are important differences in how UED and Jemena are approaching AIMRO. However, the delivery of AIMRO (functions such as budgeting, procurement, management of the roll-out, integration with the distribution networks, etc) is being managed through the joint program, which operates as a stand-alone project unit. As a result, any AIMRO-related information that JEN and UED will need to provide under budget and charges approval processes will be sourced from the joint program.

### 1.2 Opening Comments

The companies commend the ESC for preparing and publishing the comprehensive paper so quickly following the Gazettal of the revised Cost Recovery Order in Council (CROIC). Although this submission is to the ESC, the companies also look forward to working with the Australian Energy Regulator (AER), which will take over the administration of the CROIC framework from 1 January 2009. Throughout the companies' submission, the companies refer to the relevant regulator (currently the ESC, but in the future the AER) as "the Commission".

Although the companies are supportive of many aspects of the ESC's proposed approach, as set out in the Paper, there are a number of significant issues with the proposed framework and approach. If left unaddressed, these issues will result in the Commission adopting processes that:

- Are not consistent with the revised CROIC
- Result in large amounts of redundant and, in some cases meaningless, information being provided
- Place a greater-than-necessary administrative burden on the Commission in processing such information



- Place an unnecessarily high compliance cost burden on the relevant distributors in producing such information.

In the companies' view, the issues arise mainly due to how novel and different the regulatory framework established by the new CROIC is, and due to the complex nature of the roll out project itself (including the different approaches being taken by various businesses). Another likely contributing factor was the very tight time frame imposed on the ESC by the revised CROIC. This new time frame left little time for the ESC to fundamentally reconsider its approach in light of a new and different framework, which is set out in a complex legal instrument – the revised CROIC.

In the following sections, the companies provide comments on the substance of the proposed framework and approach set out in the Paper. Section 2 sets out general comments on how the Commission has approached its task, including how the Commission has interpreted the various tests and processes set out in the revised CROIC. Section 3 then sets out specific comments that relate to the matters on which the ESC has invited stakeholder comments in its Paper.

Given the number of significant concerns the companies have with the ESC's proposed framework and approach, and the tight timeframe for submitting the first budget submission, the companies would appreciate an opportunity to discuss the concerns raised in this submission with the relevant staff members of the AER as soon as possible in early January 2009.

## 2 General Comments

The new framework set up in the revised CROIC is, by design, different to most regulatory mechanisms previously administered by the Commission. While the revised CROIC borrows the “building blocks” cost build up methodology from more traditional regulatory regimes, it does not apply this framework to estimate “efficient” costs as is done in other regimes. Instead, under the revised CROIC, the “building blocks” are used to estimate the likely forward-looking costs of AIMRO (through budget applications) and to then “true-up” for actual costs (through charges applications and a true-up mechanism that survives past the end date of the CROIC).

In essence, the revised CROIC is based on the premise that all AIMRO costs incurred by distributors are to be passed through, unless the Commission is able to establish that the costs are not for AIMRO activities (are outside scope) or that the costs are not prudent (as opposed to “efficient”).

When interpreting the revised CROIC, it is important to understand that:

- The CROIC was developed in light of the Victorian Government imposing an obligation on the Victorian distributors to invest in a large-scale, risky project with an ambitious time table for what will be the first mass roll out of advance meters in Australia
- Given the above, the CROIC appropriately seeks to reduce regulatory discretion, thereby minimising regulatory risk and allowing distributors to focus most of their efforts on managing business and project risks. This was achieved by:
  - Establishing a cost pass-through (rather than an incentive-based) regulatory approach, which guarantees the recovery of all costs that are within scope and prudent. These tests are markedly different to the efficiency tests applied in other regulatory settings
  - Providing for an *ex ante* budget approval process, followed by an *ex post* adjustment for actual costs
  - Clearly defining, in a schedule to the CROIC, the scope of activities for which costs are recoverable, and providing a detailed list of activities that are explicitly in or out of scope
  - Clearly defining the prudence test in the CROIC, with little discretion in how the test is to be applied
  - Defining all contract costs to be prudent, provided that a competitive tender process was followed

- Defining all non-contract costs as prudent, provided that, in incurring those costs, the distributor did not substantially depart from the commercial standard that a reasonable business would exercise in the circumstances
- Placing the burden of proof on the regulator, where it believes that the recovery of some costs should be disallowed. Under the revised CROIC the Commission **must** allow the recovery of the costs proposed by the business, **unless the Commission establishes** that the costs are outside scope or not prudent. The companies would like to draw the Commission's attention to the consistent use of the word "**establish**" in the revised CROIC, rather than "determine", which is often used in other regulatory settings.

The Commission's Paper seeks to thoroughly address each aspect of the new regulatory framework for AMI, as set out in the revised CROIC. However, aspects of the Commission's proposed approach on a number of key issues seem grounded in traditional regulatory practice under current and past instruments (such as the approaches used in Electricity Distribution Price Reviews), rather than recognising the different nature of the revised CROIC. The companies address each of these inconsistencies below.

## 2.1 Onus of Proof

The Commission, throughout the paper, refers to "determining" or "considering" certain matters, including:

- whether expenditure is within scope
- whether expenditure has been prudent
- whether a competitive tender process has been followed, and
- whether expenditure is more likely than not to be incurred.

An important point of distinction under the revised CROIC framework (as opposed to, for example, the standard provisions of the National Electricity Rules) is that the Commission must approve AMI expenditure unless the Commission "**establishes**" that certain tests have not been met (refer clause 5C.2(a) of the revised CROIC). The Commission, therefore, cannot simply "determine" that the tests for approval have not been met, but must establish, as a legal fact, that disapproval is warranted. The onus of proof is therefore on the Commission.

## 2.2 Scope Test

In section 2.3 of the Paper, the Commission describes Schedule 2 (which sets out the scope) as "a list of activities that the distributor must undertake". This interpretation of Schedule 2 is not consistent with the revised CROIC. The revised CROIC does not require a distributor to

undertake the activities listed in Schedule 2.<sup>1</sup> Rather, Schedule 2 defines the scope of **activities for which costs are recoverable** under the CROIC. These activities are clearly defined to be:

“Those activities reasonably required: a) for the provision of Regulated Services; and b) to comply with a metering regulatory obligation or requirement”.

The above statement is the overarching scope test, while the rest of Schedule 2 simply lists specific activities that do (or do not) meet this overarching test. For any activity not explicitly mentioned in the detailed part of Schedule 2, the overarching scope test quoted above applies.

It is also important to recognise that the scope test is a factual one: “Is the activity in question reasonably required in order to provide the Regulated Services and to comply with a metering regulatory obligation or requirement?” If the answer to this question is “yes”, the activity is within scope, and so is all expenditure for that activity.

A separate prudence test then deals with the **level** of costs that is recoverable for activities that are within scope. Therefore, when applying the scope test, it would be inappropriate for the Commission to examine cost levels, including by comparing them across businesses. It would also be inappropriate for the Commission to consider any issues relating to “double recovery” of overheads and management costs as part of the scope test.

### 2.3 Competitive Tender Process Test

Much of the discussion in section 2.5 of the Paper focuses on matters that would be relevant if the Commission’s task was to determine whether contract costs are efficient. However, the prudence test set out in the CROIC is limited to a consideration of whether a competitive **process** was followed (refer clause 5C.3(a) of the revised CROIC). The focus is on the tender process used to let the contract, not on the tender outcomes. Given this important difference, the companies suggest the Commission reconsider its proposed approach when examining tender processes. Further detailed comments are provided in the companies’ specific comments below.

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<sup>1</sup> The obligations on distributors to deliver Advanced Metering Infrastructure are set out in the AMI Specifications Order.



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## 2.4 Substantial Departure from Commercial Practice

The companies note that section 2.7 simply restates the requirements of the CROIC that relate to the prudence test, which applies to non-contract costs (or contract costs that were not competitively tendered). Since the Commission has not provided its interpretation of the test, the companies are unable to comment on this issue in detail. However, the companies consider this to be an important test and would appreciate guidance from the Commission on how it intends to apply this test.

## 2.5 Data Templates

In order for distributors to provide information in the format envisaged in the Commission's proposed templates, arbitrary allocations will be required. Undertaking the re-allocation exercise will not only create information that is less meaningful than information at the source (the distributor's own financial model used for forecasting, recording and managing AIMRO costs), but will also create an unnecessary compliance burden in a process that is already severely time-constrained.

The companies have therefore proposed an alternative solution that, the companies believe, will provide the Commission with much more meaningful detailed information, while still ensuring that all expenditure is clearly related to scope. Further detail is provided in section 3.16 of this submission.

## 3 Specific Comments

### 3.1 Matters relating to establishing whether expenditure is within scope

Please refer to the companies' general comments on this matter. Section 2.3 of the Paper refers to the Commission "forming its view of whether expenditure is within scope" and "making a "decision on whether expenditure is within scope". The companies would like to re-iterate that the CROIC does not provide the Commission with discretion to simply decide that expenditure is outside scope. Rather, clause 5C.2(a) requires the Commission to approve budgeted expenditure, unless the Commission establishes that the expenditure is for activities outside scope. The wording of the clause places the burden of proof on the Commission.

### 3.2 Form and nature of the proposed audit certification

The companies would like to draw the Commission's attention to the fact that the order makes a clear distinction between the audit requirements that apply in most years (set out in clause 5H.2) and the requirements that apply for the 2011 charges application (set out in clause 5I.3). If the companies understand section 2.3.2 of the Paper correctly, the Commission is proposing to apply clause 5I.3 to all years. This appears to imply disregarding clause 5H.2. Such an approach would not be consistent with the CROIC.

The companies agree with the Commission's view that it would not be inappropriate for the auditors appointed to audit the distributors' regulatory accounts to also undertake the AMI audit.

### 3.3 Matters relating to establishing whether expenditure is a 'contract cost'

In section 2.4 of the Paper, the Commission sets out the matters it proposes to consider in establishing whether a certain item of expenditure is a contract cost. The Commission proposes that (bottom of page 16 of the Paper) distributors should provide detailed information on each contract. While the companies are happy to provide this information, if useful to the Commission, the companies note that most of this information is not relevant to establishing whether a certain item of expenditure is a contract cost. The test set out in the CROIC is purely a factual one. Therefore, the only relevant considerations for the Commission appear to be:

- Can the relevant item of expenditure be traced back to a contract, and
- Is any part of the relevant item of expenditure the result of a budget variation, as opposed to being the result of the original contract?

Furthermore, while the Commission may find the detailed information listed at the bottom of page 16 useful, the companies note that providing this information will create an onerous compliance burden, especially with respect to information such as payment schedules and break downs of payments according to the Commission's preferred 4 categories.

Much of this information is also subject to non-disclosure and confidentiality agreements between JEN, UED and the contract vendors, which were signed at the request of the vendors. The companies note that, once information is broken down according to the templates proposed, it would be relatively easy for the vendors' competitors to derive which vendor supplied what service at what price.

### **3.4 Matters relating to establishing whether a competitive tender process has taken place**

The relevant matters for the Commission to consider in making a determination in which it establishes that a contract was not let in accordance with a competitive tender process are set out in sections 5C.10 and 5I.9 of the CROIC. These matters are:

- The tender process for that contract
- Whether there has been compliance with that process, and
- Where the Commission establishes that the request for tender unreasonably imposed conditions or requirements that prevented or discouraged the submission of any tender that was consistent with the selection criteria, that fact.

In section 2.5.1, the Commission states that:

"...where a tender does not result in competitive outcomes, it may be inferred that the tender process that was followed was not a competitive one"

The companies would like to emphasise that the competitive tender test in the CROIC focuses only on the process that was followed, and not on the outcome. Also, consistent with the companies' general comments above, there is no provision in the CROIC for the Commission to infer things when applying the relevant tests. The Commission must approve the relevant expenditure, unless the Commission establishes (in the legal sense) that a competitive tender process was not followed.

The above comments also apply to the Commission's statement in section 2.5.2 that

"...the Commission will consider whether there is a clear business case demonstrating why contractual arrangements are likely to lead to better outcomes than internal provision of services"

While the companies are happy to provide such information, if the Commission finds it useful, the information appears to bear no relevance to the test set out in the CROIC. It would therefore be inappropriate for the Commission to consider such information when applying the test relating to competitive tender processes.

The information that the Commission proposes to seek (refer the four bullets on page 19 of the Paper) in relation to tenders does not appear relevant to the competitive tender process test set out in the CROIC. While the companies are happy to provide such information and discuss it with the Commission, it would be inappropriate for the Commission to consider such information when applying the competitive tender process test.

Finally, section 2.5.3, which discusses tender outcomes, is not relevant to the CROIC test relating to competitive tender processes. Since the test is focused on the tender **process**, there is no scope for the Commission to consider tender **outcomes** in determining whether a competitive process was followed.

### **3.5 Matters relating to establishing whether it is more likely than not that the expenditure will not be incurred**

On page 21 of the Paper the Commission notes that:

"The Commission acknowledges that there may be many situations where it might consider that it is more likely than not that the expenditure will not be incurred. For example:

- where the forecast expenditure on a particular cost item is so much greater than what the Commission considers a reasonable distributor should spend on that item
- where expenditure on a specific cost item is not likely to be incurred to any extent. For example, this might include a contingency amount which the Commission considers is not likely to eventuate"

Consistent with the companies' general comments above, the companies would like to emphasise that the CROIC requires the Commission to approve the relevant expenditure, unless the Commission can establish (rather than simply consider) that it is more likely than not that the expenditure will not be incurred (refer clause 5C.3 of the CROIC).

The Commission's first example also appears to not be relevant to the test set out in clause 5C.3(b)(iii) of the CROIC. The test is a factual one: "Is it more likely than not that the expenditure will not be incurred?" This test does not include a consideration of the level of costs that a reasonable distributor should spend. Therefore, only the Commission's second example appears relevant.

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### **3.6 Matters relating to establishing whether expenditure involves a substantial departure from the commercial standard that a reasonable business would exercise in the circumstances**

Section 2.7 of the Commission's paper restates the test set out in section 5C.3(b)(iv) of the CROIC, and notes that the Commission will assess each instance of relevant expenditure (non-contract expenditure, or contract expenditure where the Commission has established that a competitive tender process was not followed) on a case-by-case basis.

The companies would appreciate additional guidance on how the Commission interprets and intends to apply this test. The companies would like to draw the Commission's attention to the fact that the test focuses on the **commercial** standard that a reasonable business would exercise, and whether incurring the relevant cost would involve a **substantial** departure from such a standard. In the companies' view, the main consideration for the Commission when applying this test, is whether it was unreasonable for the distributor to incur the expenditure in the way it was incurred, given the other genuine options available to the distributor at the time and under the circumstances.

In section 2.8, the Commission proposes to consider a number of additional matters when applying the "substantial departure from a commercial standard" test to related party contracts. The companies note that the CROIC contains no special provisions for related party contracts or expenditure. The companies also note that all of the Commission's proposed considerations appear to introduce economic efficiency tests that are not envisaged in the CROIC. The companies therefore do not consider the Commission's proposed considerations to be appropriate. In the companies' view, where the Commission establishes that a related party contract was not competitively tendered, the same generic test outlined in the previous paragraph should apply.

### **3.7 Methodology the distributors should use to calculate the market observables for their February 2009 budget applications**

While the companies generally agree with the Commission's treatment of this issue, the companies note that the proposed statement of intent from the AER uses, as risk-free rate proxy, a Commonwealth Government Bond with a term that matches the regulatory period. The Commission's discussion of this matter in section 3.2.2 does not clarify what the Commission considers to be the regulatory period for AMI. In the companies' view, the regulatory period is the period between the Start Date (1 January 2009) and the End Date (31 December 2015), as defined in the CROIC. This is the period during which the unique regulatory framework of the revised CROIC applies, at the completion of which regulation of metering services reverts to the 5-yearly Electricity Distribution Price Review cycle.

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### **3.8 Methodology the distributors should use to determine equity raising costs**

The companies agree with the principles behind the Commission's proposed approach, with the aim being to compensate businesses for actual, rather than benchmark, equity raising costs. However, the Commission should note that, at the time of submitting a budget application, the proposed equity raising costs may either be actual or forecast.

### **3.9 How the benchmark costs should be adjusted for the purpose of the ECM, particularly in relation to metering data service IT costs**

The companies make no comment on the Commission's treatment of this issue at this stage.

### **3.10 Matters relating to ensuring that reported costs represent the true value of costs incurred**

The companies note that the relevant amounts will be taken from distributors' audited regulatory accounts. The companies are not certain what, if any, additional scrutiny of the costs would provide incremental comfort to the Commission, but are open to discussing this further with the Commission, if useful.

### **3.11 Whether there should be the potential for a net negative carryover from the 2006 to 2008 period**

The companies make no comment on the Commission's treatment of this issue at this stage.

### **3.12 Matters relating to establishing the benchmark cost of tax in respect of the AMI rollout**

The companies make no comment on the Commission's treatment of this issue at this stage.

### **3.13 Proposal to use straight line depreciation to determine the amount of regulatory depreciation**

The companies agree that the use of straight line depreciation is appropriate.

### **3.14 Additional pricing principles, if any, to which regard should be given when considering distributors' charging proposals**

In section 4.1 of the Paper, the Commission states that:

“The revised Order provides that charges for regulated services shall be determined as if the current price determination continued to apply for that year and the regulated services were prescribed metering services.”

In the companies’ understanding, the Commission is referring to clause 5J of the revised CROIC. The companies note that clause 5J applies only to charges in the year commencing 1 January 2009. Clause 5J does not apply to charges in any other year.

In section 4.2 of the Paper, the Commission correctly notes that, other than for charges in the year 2009, the revised CROIC:

“...does not provide guidance in relation to matters including:

- the way in which individual charges should be calculated including the need for cost reflectivity
- the need for rebalancing constraints, and the level of any rebalancing constraints”

However, the Commission goes on to discuss the applicability of pricing principles from its December 2007 framework and approach, or, as an alternative, distribution pricing rules in section 6.18 of the National Electricity Rules (NER).

In the companies’ view neither of the alternative proposed pricing principles are relevant nor appropriate considerations for the Commission, other than in relation to charges in the year 2009. The revised CROIC does not provide for the application of pricing principles to individual charges, or rebalancing controls to charges for Regulated Services. The constraints on charges from 2010 onwards are clearly set out in clauses 4.1(o) and (p). It would be inappropriate for the Commission to apply any additional constraints that are not provided for in the CROIC.

In particular, section 6.18 of the NER is not relevant, as it deals with the pricing proposals to be submitted after the publication of a distribution determination. However, metering services are not regulated under a distribution determination while the CROIC remains in force.

### **3.15 Matters relating to establishing that charges for unmetered supplies are consistent with the revised Order**

The companies make no comment on the Commission’s treatment of this issue at this stage.

### **3.16 Draft data templates**

The Commission has proposed a set of detailed data templates that, in the companies’ understanding, primarily seek to collect a discrete dollar value for each individual line item of the scope. While the companies are able to produce this information (albeit with some

necessary amalgamation of line items), it would require arbitrary cost allocations that would not only be time consuming, but also render much of the data meaningless, making it of little use to the Commission. Furthermore, given the arbitrary allocations required, comparisons between budgeted and actual amounts, as well comparisons of actual incurred amounts over time, would have little meaning. The compliance burden created in artificially creating these numbers on the basis of the joint program's financial model would also be significant.

The companies note that the CROIC does not require the Commission or the distributors to establish a dollar value for each scope line item. Rather, clause 5B.1(d) requires that a budget application must relate the expenditure to scope. This exercise is clearly important to ensure the Commission has comfort that no expenditure has been proposed that is outside scope.

Below the companies propose an alternative solution that, the companies believe, would provide the Commission with much more meaningful detailed information, while still ensuring that all expenditure is clearly related to scope.

Attached to this submission is a set of alternative templates proposed by the companies. These templates are derived directly from the financial model that is used by the joint program to forecast and track AIMRO costs. Information provided using these templates would provide the Commission with detailed and meaningful information that is used to manage the joint program, including making decisions on expenditure and formulating the risk management strategy. Over time, information provided using these templates would allow for meaningful tracking of actual expenditure against budgeted expenditure, and of changes in expenditure over time.

It is also worth noting that, to the extent that the Commission's final templates for the companies differ from those proposed in this submission, the companies will need to reallocate information from the joint financial model before submitting it to the Commission. Thus, the original source of the information to be provided to the Commission will, in any case, be a model structured as per the templates attached to this submission.

In providing these templates, it was also the companies' intent to provide a mapping document that clearly relates each line item in the companies' proposed templates to the relevant line item(s) of scope, as set out in the revised CROIC. Due to resource constraints over the Christmas period, the companies have not been able to produce this document in time for the submission deadline. However, the companies intend to provide this document to the Commission by January 14.

Finally, the companies would like to note that it is unlikely that one set of templates will be suitable to all businesses. The companies therefore encourage the Commission to adopt tailored templates for individual businesses, if needed.

### 3.17 Proposed Regulatory Timeframes

Table 5.1 on page 49 of the Paper implies that distributors will submit both the initial AMI period budget submission and the initial charges application on 27 February 2009. In the companies' view, this interpretation is inconsistent with the CROIC. Section 5A.1 of the





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CROIC does not envision a charges application on 27 February 2008, but only a budget application. The charges application must be made by 1 June 2009.

Other than the issue above, the companies agree with the Commission's proposed timeframe in table 5.1.



## AIMRO Model - Operational Opex

### TOTAL PMS COSTS

#### Meter Management

Retailer Service Orders ***	
Read Data & Send	
Manage Meter Assets	
Customer Relations*	
	0

#### Network Management

Manage Operations	
Manage Outages	
Strategic Planning *	
Manage AIMRO Comms	

#### Revenue Management

Pricing	
Billing (UCMS)	
	0
	0
	0
	0

#### Asset Operations

Meter Disconnection *	
Comms/Meter Reboot	
Rollout Claims & Complaints *	

Total

Check

### INCREMENTAL DUOS COSTS

#### Meter Management

Retailer Service Orders ***	
Read Data & Send	
Manage Meter Assets	
Customer Relations*	
	0

#### Network Management

Manage Operations	
Manage Outages	
Strategic Planning *	
Manage AIMRO Comms	

#### Revenue Management

Pricing	
Billing (UCMS)	
	0
	0
	0
	0

#### Asset Operations

Meter Disconnection *	
Comms/Meter Reboot	
Rollout Claims & Complaints *	

Total

Check