



Essential Services Commission

**A practical application
of the PREMO framework**

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1. Executive Summary

How will PREMO benefit Victorian customers?

PREMO will require businesses to work with customers to listen to and act on their interests, preferences and priorities and to reflect these in their submissions. Businesses will only be able to recover higher levels of return if they can demonstrate that they are delivering what their customers want and commit to ongoing engagement to demonstrate that they are delivering what they promised.

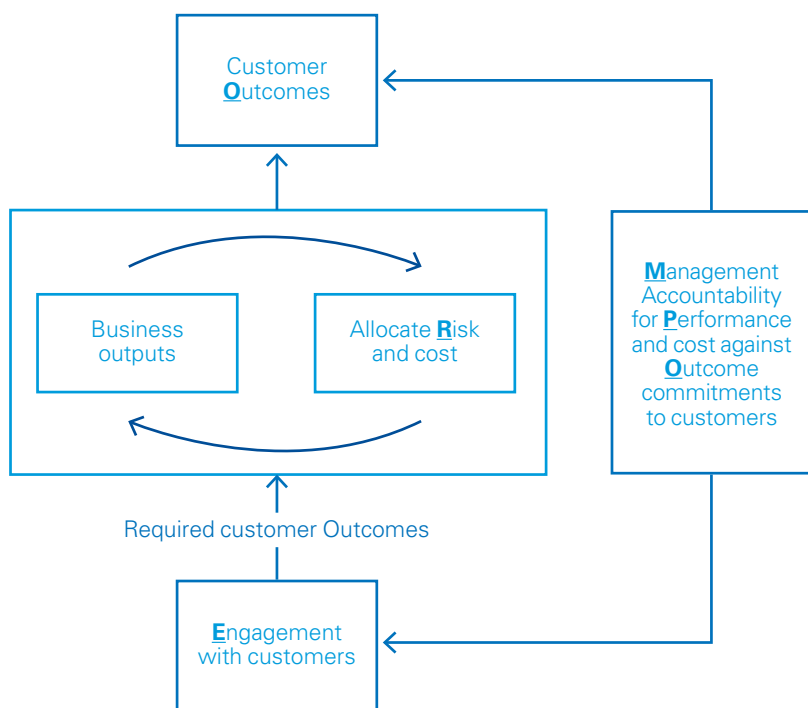
The Essential Services Commission (the Commission) will introduce a new approach to the way that it sets the prices for the Victorian water businesses in 2018. This provides a significant opportunity to ensure that the regulation of water prices is in the long term interests of Victorian customers.

The new approach is known as “PREMO” (**P**erformance, **R**isk, **E**ngagement, **M**anagement accountability and **O**utcomes). It will incentivise water businesses to work with their customers and deliver outcomes that reflect customers’ priorities. PREMO will:

- Require businesses to work with their customers to develop a submission that meets each of the four PREMO assessment elements: **R**isk, **E**ngagement, **M**anagement accountability, **O**utcomes (the **PREMO elements**).
- Require businesses to self-assess that submission against four possible ratings: Leading, Ambitious, Standard and Basic.
- Involve the Commission in completing its own assessment, looking at each submission, and also completing a relative comparison between businesses.
- Allow the Commission to set the level of return that each business will be allowed to earn during the regulatory period, based on the two assessments.
- Include ongoing monitoring of **P**erformance during the regulatory period, and potential for the Commission to take action if a business does not deliver to their customers what they have promised.

How the PREMO elements combine to improve customer outcomes is illustrated below.

Figure 1: Interaction of the PREMO elements



This diagram illustrates how the PREMO framework requires:

- a business to use customer engagement
- to identify the outcomes that customers require,
- and manage risk, cost and resulting outputs
- to deliver those customer outcomes, and
- whose performance the business must manage and be accountable to customers for.

The recommendations contained in this paper will be explored in a workshop to be hosted by the Commission on 19 September 2016.

To guide the Commission in implementing this new framework, KPMG were engaged to answer two overarching questions:

1

What is the form of the assessment framework to be applied to PREMO; and

2

How should prices be adjusted to account for performance against the delivery of proposed outcomes?

1.1 Our recommendations

1.1.1 What is the form of the assessment framework to be applied to PREMO?

We have made recommendations for:

- Guiding questions for self-assessing against each element of the PREMO framework, a *PREMO Assessment Tool* and a set of sub questions to guide accurate ratings;
- A scoring approach to assessing ratings against each element of the PREMO framework; and
- How the Commission, and indeed the businesses, should assess the businesses' PREMO element self-assessments, to provide an overall assessment.

1.1.1.1 Completing a self-assessment

The following table provides:

- Guiding questions for businesses and the Commission to assess a pricing submission against each of the "REMO" elements. Assessment

against P is detailed separately in section 1.1.5 because unlike the REMO elements, the Performance element contributes to an ex-post assessment of the implementation of the proposals contained within a pricing submission; and

- Examples of the types of high level actions a business could take that would be consistent with a "Standard" rating under each REMO element. These examples are intended to provide guidance only and do not comprise a "tick-the-box" checklist of what a business needs to do to achieve a standard rating for each element of REMO. This form of checklist would not provide appropriate incentives for businesses to put forward their best submission, nor would it provide the Commission with flexibility in undertaking a comparative assessment of all submissions.


A more complete list of what might represent a "Standard" price

submission is provided in the *PREMO Assessment Tool* (the Assessment Tool). We have provided examples here only to provide a high level description of our proposed assessment framework.

The Assessment Tool also includes guiding examples on what may constitute "Leading," "Ambitious," and "Basic" price submissions. It is the main resource that businesses should use to undertake their self-rating.

We have provided more guidance on the features of a price submission with a "standard" rating, as this rating is intended to represent what is expected of a well-run water business that continues to seek to minimise cost, and deliver improving customer value. Further, a standard rating will earn a return on equity commensurate with current good practice in the Victorian water sector. All businesses should seek, as a minimum, to achieve a standard rating.

Table 1: REMO assessment guiding questions and examples of actions consistent with a "Standard" rating

PREMO element	Guiding questions	Examples of a "Standard" submission
 Outcomes	<ul style="list-style-type: none"> • Has the business provided evidence that the outcomes proposed have taken into account the views, concerns and priorities of customers? • Has the business provided sufficient explanation of how the outcomes it has proposed align to the forecast expenditure requested? • Has the business proposed outputs to support each of its outcomes, which are measurable, robust and deliverable? • Has the business justified that the outputs it has proposed align with the outcomes? • Has the business demonstrated a reporting and stewardship process to measure performance against each outcome and to inform customers? 	<ul style="list-style-type: none"> • The outcomes proposed generally reflect customer preferences and priorities revealed through engagement. • In any instances where outcomes proposed are not consistent with customer views, the business has justified why this is so within its submission. • The outcomes proposed are broadly consistent with existing levels of service provided to customers. • The business has mostly defined outcomes in ways that reflect the customer service experience (See Chapter 3). • The business has committed to and described a process for monitoring and reporting to customers, within period performance against outcomes.

PREMO element Guiding questions

Examples of a “Standard” submission

Management



- Has the business provided **evidence** that there is senior level, including Board level, ownership and commitment to its submission and its outcomes?
- Has the business **demonstrated** how its proposed prices reflect only prudent and efficient expenditure?
- Has the business provided sufficient **justification** of the quality of the submission, including the quality of supporting information on forecast costs?

- The senior executive team and Board of Directors acknowledge and can attest, (e.g. through some form of “Responsibility Statement,” or a statutory declaration), that it has undertaken appropriate internal procedures to assure themselves of the quality and accuracy of their price submission.
- The price submission addresses all requirements specified in the Commission’s Guidance Paper.
- The price submission contains no material or obvious errors or omissions.
- The price submission assumes productivity improvements built into forecast expenditure, at a rate at least equivalent to the Commission’s one per cent controllable operating expenditure efficiency hurdle (used in 2013 water price review).
- The business has sought to absorb the impact of any “cost push ins”

Engagement



- Has the business **detailed** and **justified** alignment of its customer engagement process with the IAP2 Public Participation Spectrum?
- Has the business **demonstrated** that it has engaged with a broad range of customers in developing its submission (Form)?
- Has the business **demonstrated** that it has engaged with its customers about a range of issues relating to its submission (Content)?
- Has the business **explained** how it decided when to engage with its customers (Timing)?
- Has the business **explained** how its engagement with customers has influenced its submission?

- The business demonstrates that engagement has occurred on matters that customers reveal are the most important to them.
- A business demonstrates that engagement was undertaken early, prior to locking in key strategies and priorities.
- A business demonstrates that the business re-tested its position and proposals with customers as it developed its price submission.
- The form of customer engagement is justified as being fit for purpose given the content and circumstances facing the business and its customers.

Risk



- Has the business **demonstrated** a robust process for identifying risk, and how it has decided who should bear these risks?

- The business meets the requirements of the Statement of Obligations and the Commission’s Guidance Paper in relation to risk.
- The business can demonstrate compliance with risk standards specified in the Statement of Obligations, such as ISO 31000.
- The unit rates used to evaluate projects and options reflect recent historical trends, and/or independently verified market forecasts.
- The business can demonstrate that it has thoroughly evaluated the feasibility of commencement and completion dates for major projects.

Within the previous table, we have highlighted key words such as “explain”, “justify”, “demonstrate”, “detail”, “evidence” etc. Whilst the answers to these questions may be binary (e.g. “yes” or “no”), each business will need to explain, within its price submission and supporting documents submitted to the Commission, how it has come to this conclusion. It will not be good enough to tick each box and assume a leading or ambitious rating. Each business should be able to demonstrate the basis for its answer. The Assessment Tool recommends to the Commission, guidance for self ratings.

1.1.2 Application of the guiding questions

To achieve an overall standard rating, a water business would need to detail, justify and validate the inputs, activities and associated costs in its pricing submission, as being consistent with current good practice in the Victorian water sector. It must have:

- Defined a set out outcomes with its customer base through early, broad and targeted engagement on issues related to customer value; and
- Submitted a set of proposals that:
 - Seek to minimise cost and price impacts on customers;
 - Transfer risk to the party best placed to manage it; and
 - Have been through a rigorous internal assessment process to ensure completeness, accuracy, consistency, robustness and validity of all information and documentation submitted.

A response that does not provide this information will result in a business risking a basic rating, and/or moving into the “red zone”, which may result in a business being required to re-submit its submission, and/or receiving a shorter regulatory period.

The Assessment Tool details the requirements of a standard rating under each element of REMO (i.e. consistent with good practice in the Victorian water sector) and the additional requirements to be rated “ambitious” or “leading”, or indeed the risks of being downgraded to “basic”. It is not intended to be the only solution, as a business could achieve higher, and or lower ratings in some categories and still achieve a standard rating under the proposed overall scoring approach. Similarly, our examples are “stand-alone” and are not designed to imply a package of answers to be graded as standard under the relevant questions.

Appendix 1 provides more detailed sub-questions the Commission may require each business to consider, prior to completing its self-assessment, and Appendix 2 provides detail of the UK precedent supporting our proposed assessment framework.

To achieve an overall ambitious or leading rating, a business would need to:

- Propose an ambitious set of outcomes decided by customers, and to undertake a process that allows customers to influence every aspect of its pricing submission, including prices and expenditure;
- Submit a set of proposals that:
 - Reduce the cost of service delivery and reduce prices faced by customers;

- Accept more risk on behalf of customers, whilst promoting effective financial management; and
- Demonstrate a rigorous internal assessment process through a complete, accurate and consistent set of documents and supporting information that are independently validated and tested, and explicitly meet the requirements of the Commission and legislation.

1.1.3 Guidance from the Commission

We recommend that the Commission publishes in advance its guiding questions that will apply to all businesses, as well as the Assessment Tool, to assist the businesses in undertaking a self-assessment for each element of REMO. Businesses will need to consider how best to answer each question based on their understandings of what their customers want and need. **It will be critically important for a business to link its customer engagement with the service outcomes and other proposals contained within its pricing submission.**

1.1.4 Scoring approach





We recommend that the Commission requires each business to:

- Use a form of “traffic light” assessment of its submission against each REMO element, scoring its submission using a rating of either Leading (green), Ambitious (yellow), Standard (amber) or Basic (red), by reference to the guiding questions described above; and

- Detail and justify its overall self-assessment based on this traffic light assessment, by addressing each of the guiding questions and sub-questions detailed for each element of PREMO.

An example of traffic light assessments of four different businesses is provided below. Section 1.1.4.1 provides detail of what these individual scores will mean to informing the overall score.

Table 2: Proposed scoring approach

Business	 Risk	 Engagement	 Management Accountability	 Outcomes
A	Leading (Green)			
B	Leading (Green)	Standard (Amber)		Ambitious (Yellow)
C	Standard (Amber)	Leading (Green)		
D	Basic (Red)		Ambitious (Yellow)	

■ Leading
 ■ Ambitious
 ■ Standard
 ■ Basic

1.1.4.1 How should an overall score be determined?

We recommend the following four-step process:

- 1 The business undertakes a self-assessment against each element of REMO, using the guiding questions described above, and the Assessment Tool;
- 2 The business determines an overall score, based on the recommended approach described below;
- 3 The Commission undertakes an assessment of the business’s price submission against each element of REMO, utilising the guiding questions and the Assessment Tool; and

4 The Commission then undertakes a comparative assessment of all of the pricing submissions, to ensure that the overall ratings, as a collective, make sense.

To determine an overall score (consistent with 1 and 3 above), we recommend the following approach:

- For a “Leading” rating, a business’s submission would need to score “green” in all four REMO elements at both self-assessment and the Commission’s assessment. This is consistent with Ofgem’s approach for deciding whether to fast-track any energy businesses. Ofgem restrict this to businesses scoring “green” across all RIIO elements.

- An average score is appropriate for those businesses that score a mix of ratings across the four REMO elements. For example, a leading rating would receive a score of 4, with a decrement of 1 for each subsequent lower rating. An arithmetic average would then be calculated across the REMO elements. This average would then be compared to the range of scores related to the overall rating (e.g. a score between 3 and 3.99 would result in an ambitious rating, a score between 2 and 2.99 would result in a standard rating etc.). Where a rating is at the margins, the Commission could provide for a within period adjustment, as described in Section 1.1.5.1.

How does this benefit Victorian customers?

Customers will now have a central role in determining what services are necessary to meet their needs. They will have a stronger relationship with their water service provider, and greater say over how the business plans for the services it provides. There will be greater transparency for customers regarding how forward planning is undertaken, through agreement of a set of outcomes that reflect their views. Further, the PREMO framework will incentivise businesses to manage more risk on behalf of customers, to alleviate bill pressures.

To ensure that the individual ratings make sense collectively, we recommend that the Commission applies its own judgement to the colour scores when deciding on an overall rating of a business. The Commission's final decision on each submission would take into account the quality of the submission against each guiding question, but the Commission may also want to consider:

- The track record of each business in delivering against previous commitments and any ongoing customer related issues such as current rates of customer complaints; and/or

- A comparative assessment, by comparing submissions against one another to encourage competition between businesses and to identify those that truly demonstrate a leading approach.

We understand that the Commission will clarify that businesses will be obliged to accept the final rating that they are given, and that appeal is not an option. That said, as part of its 2018 water price review, the Commission will publish a draft decision - this will include its views on the rating of a business's price submission. This may provide an opportunity for businesses to challenge the Commission's initial price submission rating. However, we strongly recommend that the basis for any challenge needs to be on grounds related to the Commission's assessment process (e.g. inconsistent application of the Assessment Tool in rating the business relative to another business). The grounds for challenge should not include matters related to changed expenditure, risk or demand forecasts for example. This would undermine the objective of PREMO to get businesses to put forward the best and final offer to customers in their price submissions.

1.1.5 How should prices be adjusted to account for performance against the delivery of proposed outcomes?

The Performance element of PREMO is designed to ensure that businesses are responsible for "delivering" the outcomes agreed with customers through engagement. What this means is ensuring there is a process for monitoring performance, and take remedial actions should there be a material difference between that which was proposed, and actual performance.

We have considered:

- Adjusting prices to account for performance;
- Adjusting prices to account for uncertainty; and
- Performance monitoring and reporting.

1.1.5.1 Adjusting prices to account for performance

The PREMO framework can be thought of as requiring a business to provide a set of *minimum* customer outcomes. Should a business fail to deliver on the customer outcome commitments included in its pricing submission, it would have not kept its side of its agreed "bargain with customers".

On this a basis it would be:

- Appropriate for the Commission to financially penalise businesses that consistently underperform against outcome commitments agreed in a pricing determination. A mechanism could be established that allows for the recovery of the difference between the rate of return on equity determined at the outset of the regulatory period, and the rate of return that would have been determined had the rating of the ambition of the submission been consistent with the actual level of subsequent performance. Any recovery adjustment would require very clear and explicit justification by the Commission;
- Inappropriate for the Commission to increase a business's return on equity for outperformance of a determined rating, unless a pricing submission includes a mechanism to reward outperformance agreed with customers. To do so:

- Absent customer engagement, would be inconsistent with the objectives of PREMO;
- Would lessen the incentives for a business to seek an ambitious or leading rating for its pricing submission, in the knowledge that within period outperformance would be financially rewarded; and
- Would have the effect of reopening a regulatory determination for the period and present the possibility of the regulatory process becoming one of continuous negotiation. This could reduce certainty for customers and introduce additional costs.

An exception to this may be where the Commission's overall rating falls just short of the business's self-assessment rating. For example, the Commission agrees with three of the individual ratings against EMO (leading), but determines a lower rating for R (ambitious), such that it takes the business's overall rating from one level of ambition (leading) down to another (ambitious, as a green rating is needed on all four elements).

If the business was able to demonstrate performance consistent with its self-assessment rating within the period, the Commission could then choose to reopen the control, and adjust the level of returns upwards for the rest of the regulatory period. This would provide an incentive for those businesses penalised for over-rating their self-assessment, to continue to improve within the regulatory period.

Incentives to outperform would be provided by the Commission recognising prior years' outperformance as evidence to support the credibility of a leading or ambitious subsequent price

submission, in the same way as lacklustre historical performance would be less likely to support a future price submission.

1.1.5.2 Adjusting prices to account for uncertainty

We recommend that the Commission maintains its current approach to allowing for uncertainty mechanisms, as documented in its 2013 Guidance Paper.² We observe that this mechanism could be more workable if businesses were allowed to nominate these events within their submission and to clearly define the threshold hurdles for an adjustment to occur. This could provide greater certainty for trigger events during the regulatory period.

1.1.5.3 Performance monitoring and reporting

Through the Commission's existing performance reporting process, it should collect annual data from each business, sufficient to allow it to monitor performance against the outcome commitments made by each business in their pricing submission.

The Commission should expect each business to prepare an annual report for their customers that outlines its performance against what it has promised, in an accessible and customer-friendly manner. It need not prescribe the method for reporting. Good examples of such reports are available from the UK precedents in Chapter 3.

The Commission would retain the option to request data from any of the businesses, at any time during the regulatory period, and the ability to audit performance data provided.

How does this benefit Victorian customers?

The new PREMO framework incentivises businesses to not only propose a set of outcomes that reflect customer views, but also to deliver these outcomes and regularly report performance. Penalties for businesses that fail to deliver on their promises will provide bill reductions to customers. Reporting arrangements will ensure customers know how a business is performing against the agreed outcomes.

While we have set out in Chapter 4, the *PREMO Assessment Tool* and Appendix 1, guidance on how to demonstrate delivery against each guiding questions, the businesses alone will be responsible for taking the initiative, justifying their approach, and demonstrating how their performance meets the PREMO rating levels that they are aiming for.

Over the next few months, the Commission will require businesses to develop pricing submissions that show how they have risen to the challenge of PREMO and what they will deliver from 2018. The framework set out in this report is flexible to allow businesses to consider how to demonstrate delivery against each guiding questions, particularly for Leading and Ambitious ratings.

2. Essential Services Commission 2011, *2013 Water Price Review – Guidance on Water Plans*, October.

2. Introduction

The Commission is the economic regulator of the Victorian water sector. The Commission regulates the 19 State Government-owned water corporations in Victoria.

Since 2004, the Commission has applied a “one size fits all” approach to setting the prices that these corporations can recover from their water customers. In April 2015, the Commission published a consultation paper to review its pricing approach. This provides a significant opportunity to make the regulation of water prices work in the long term interests of Victorian customers.

The Commission will introduce the new pricing approach in the 2018 Water Price Review. This will set prices from 1 July 2018.

The State of Victoria has previously been a leader in new regulatory approaches for utilities (it led the most successful introduction of retail electricity switching/competition yet seen in any jurisdiction) and PREMO intends to give Victorian customers real comfort that their interests are being actively monitored. The Commission has recognised that the UK energy and water sectors have, in recent years, introduced variants of PREMO, and it seeks an understanding to enable it to apply best practice and avoid weaker ideas and unintended consequences.

2.1 Our task

The revisions to the water pricing approach, and the introduction of “PREMO” (Performance, Risk, Engagement, Management, Outcomes) will be a significant change in the approach to water regulation in Victoria. It intends to incentivise businesses to work with their customers and to deliver outcomes for them, and correspondingly reward businesses who show ambition and take risks on behalf of their customers.

Our report focuses on two key parts of the PREMO incentive mechanism:

- The assessment framework, including self-assessment by the water businesses and the Commission’s assessment; and
- Incentive mechanisms that link price movements to performance outcomes.

2.2 Purpose

The purpose of this report is to assist the Commission to determine:

- The form of the assessment framework to be applied to PREMO; and
- How prices should be adjusted to account for performance against the delivery of proposed outcomes.

2.3 Our evidence

We have focused on the UK's approaches to network regulation in energy (known as RIIO) and water (known as PR14).

Table 3: UK precedent used to inform our recommendations

Name	RIIO - Revenue = Incentives + Innovation + Outputs	Price Review 2014 (PR14)
Scope	Great Britain (GB) electricity and gas networks, at distribution and transmission levels	GB water and sewerage businesses and GB water only businesses
Introduced	RIIO handbook published October 2010 ³ First RIIO price controls introduced on 1 April 2013	Methodology and expectations for PR14 published July 2013 ⁴ PR14 price controls introduced on 1 April 2014
Regulator	Office of Gas and Electricity Markets (Ofgem)	Water Services Regulation Authority (Ofwat)

Further details of the RIIO and PR14 frameworks, how they work in practice, and the potential options for PREMO to consider, are set out in the body of this report and in Appendices 2 and 3.

2.4 Our report

We have focussed our report on the key elements of most relevance to PREMO and how PREMO could be implemented by the Commission for the 2018 Water Price Review. While there is a great deal to learn from the UK, the key success factor will be to tailor the PREMO framework so that it delivers the best outcomes for Victoria's water customers.

3. <https://www.ofgem.gov.uk/publications-and-updates/handbook-implementing-riio-model>.

4. http://www.ofwat.gov.uk/wp-content/uploads/2015/12/pap_pos201307finalapproach.pdf.

3. Designing Outcomes

Under PREMO, the Commission will require businesses to define the Outcomes that they are aiming to achieve. Outcomes tend to be high level, and focus on areas where businesses can improve their performance on a few key areas. Businesses will be required to engage with their customers to understand their preferences and priorities. Businesses will then need to define outcomes which their submissions will focus on.

The purpose of this chapter is to provide some clarity regarding what is meant by outcomes, compared to (for example) outputs, and how these differences are dealt with under the UK's regulatory frameworks.

It is not intended to prescribe what outcomes should be delivered, or a set of outputs, as these should be discussed and agreed by water businesses with their customers. After the first set of price submissions is concluded, certain outputs will be accepted as meeting a range of outcomes. However, it does not end at that point. PREMO is a dynamic model that provides for initiatives and improvements for customers.

3.1 Introduction

It can be difficult to measure outcomes, because they tend to be high level and subjective. For example, improved customer service might be an outcome that customers view as a priority.

In order to measure delivery against an outcome, businesses will also need to set out specific output measures. Outputs are specific targets that can be objectively measured. Businesses will need to demonstrate that customers have helped them to develop their output measures and targets, and that those customers agree that delivery of the outputs will help to achieve the related outcome. These outputs will then inform the input assumptions the business adopts in the preparation of its pricing submission and supporting documents/models, and the various activities proposed by its submission.

The following figure is a stylised example of this process.

Figure 2: Process for defining outcomes

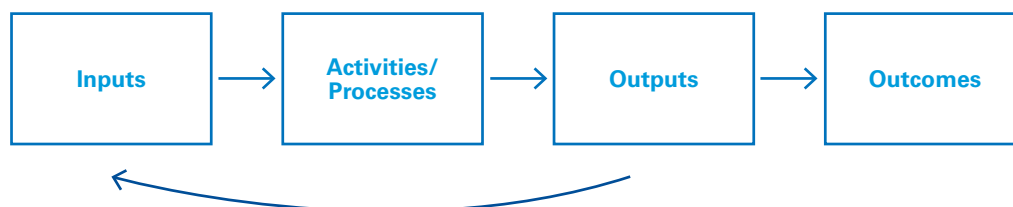


Figure 3: Example of outcome and associated outputs

Possible outcome: Improved customer service

Possible outputs:

[XX]% [xx] per cent of customer calls to businesses answered within [xx] seconds;

[XX]% [xx] per cent of customer complaints resolved within [x] working days

[XX]% [xx] per cent of customers rate their experience as satisfactory or very satisfactory, based on an annual customer survey of at least 1,000 customers

[XX]% Rate of customer complaints is less than [xx] per cent each year

[XX]% Customers are able to contact the water business 24 hours a day, and through different communication channels (e.g. telephone, website etc.).

3.2 Ofgem’s approach to designing and assessing outcomes

Under RIIO, Ofgem have adopted an outputs based approach. The aim was to move away from a focus on “input” based measures (such as the length of mains removed) and focus on outputs (such as the level of risk removed)⁵.

Ofgem set out two high level outcomes, or objectives, for the RIIO approach. These outcomes are the same for all network businesses

(gas and electricity, transmission and distribution) and are intended to remain stable for the longer-term.

These are:

- Play a full role in the delivery of a sustainable energy sector; and
- Deliver long-term value for money network services for existing and future consumers⁶.

Recent examples from the UK are provided within this chapter and relevant sources for information provided are identified in Appendix 5.

5. RIIO-GD1: Final Proposals – Supporting document – Outputs, incentives and innovation. December 2012.

6. Handbook for implementing the RIIO model. October 2010. Chapter 6

3.3 Output categories

Ofgem then set out six output categories, with the expectation that businesses need to demonstrate delivery under each category, in order to deliver against the two overall outcomes. These categories are:

- 1 Customer satisfaction;
- 2 Safety;
- 3 Reliability and availability;
- 4 Conditions for connection;
- 5 Environmental impact; and
- 6 Social obligations.

Business are “held to account” for delivering these outputs in return for the revenue that they are allowed to recover from customers. Ofgem set out these six output categories in their RIIO Handbook⁷, with the expectation that businesses would need to demonstrate delivery under each category⁸. Ofgem consult on the behaviours that they want to encourage under each output category as part of their strategy consultation for each price review. This is then confirmed in their strategy decision. Businesses must then develop a business plan submission that delivers against these requirements.

3.3.1 Primary outputs

Ofgem also define a set of primary outputs for each output category as part of their strategy decision. These are intended to reflect what customers actually want to be delivered⁹. Ofgem published principles in the RIIO handbook for primary outputs, stating that they should be material, controllable, measurable, comparable, applicable, compatible with the promotion of competition and legally compliant¹⁰. Businesses are required to propose how they can best deliver against each primary output.

Ofgem set minimum levels of performance for businesses to meet, based on Ofgem’s engagement with stakeholders. Businesses are able to propose more ambitious (or less ambitious) targets and/or alternative measures where they can present a compelling case for this change including through evidence of stakeholder engagement.

7. In practice, Ofgem have applied each of the output categories above to the gas distribution and electricity distribution businesses. The electricity and gas transmission businesses have separate output categories for reliability and availability (item 3) and do not have a specific output category for social obligations (item 6).

8. Handbook for implementing the RIIO model. October 2010. Chapter 6.

9. Handbook for implementing the RIIO model. October 2010. Chapter 6.

10. Handbook for implementing the RIIO model. October 2010. Chapter 6.

Example 1: UK electricity distribution business

Primary outputs category – Reliability

Outputs measure – Guaranteed standards of payment for customers, in the event that the business fails to meet a target for delivery set by Ofgem.

Western Power Distribution (WPD) included in its submission a statement committing to voluntarily double the value of payments made to customers in the event of a failure to achieve a guaranteed standard.

WPD included a summary of the views of its stakeholders under each of the primary outputs sections of its submission. The business stated that its stakeholders had found that the values of payment under guaranteed standards were too low, and that when failures had occurred, customers had been inconvenienced. This led WPD to its voluntary commitment of doubling the value of payments offered.

Example 2: UK electricity distribution business

Primary outputs category – Customer service

WPD set out a number of output commitments under the primary output for customer service. These included the following outputs, in addition to the standard baseline set by Ofgem:

Customer service

- To continue to be the number one performing Distribution Network Operator (DNO) group across all elements of the Board Measure of Customer Satisfaction.
- Maintain certification to the Customer Service Excellence standard.

Telephone response

- Respond to telephone calls quickly, answering them within two seconds.
- Ensure abandoned calls are less than 1 per cent.
- Always provide customers with the option to speak with a call taker.

Communication with customers

- Provide a restoration time for every outage.
- Call back all customers who have been in contact about a fault.

- Provide on demand messaging via text and social media for customers who want to be kept informed by means other than the telephone.

Stakeholder engagement

- Continue to host a Customer Panel where the CEO will meet with WPDs - expect stakeholders four times a year.
- Continue to host an annual round of six stakeholder workshops.

Complaints

- Resolve at least 70 per cent of complaints within one day.
- Continue to have a target of zero complaints where the Ombudsman has to get involved.

The business set out in its submission a summary of the views raised by stakeholders and how these had shaped the outputs WPD had proposed. For example, the output commitments on communication with customers was in response to stakeholder views where other organisations were offering alternative technology as a way of communicating, and that this should be implemented quickly by WPD and at no extra cost to customers.

WPD was awarded fast track status in RIIO-ED1.

Example 3: UK electricity distribution business

Primary outputs category – Reliability

Outputs measure – Guaranteed standards of payment for customers, in the event of an interruption to supply.

The guaranteed standards require businesses to automatically pay compensation to customers suffering an unplanned supply interruption for a continuous period of 24 hours. If a storm is “severe” then the interruption period is increased to 48 hours before customers are eligible for compensation.

In late 2016, a severe weather event occurred in

Electricity North West’s (ENW) region. Over 68,000 customers were affected. The business announced that it had set up a team to deal with compensation requests.

The business received 22,000 requests for “goodwill” payments. The business later confirmed that the weather event was “severe” and it would only be issuing compensation payments to those customers continuously off supply for 48 hours. This caused adverse publicity for ENW, and the matter was raised by an MP in a letter to Ofgem.

3.4 Ofgwat’s approach to designing and assessing outcomes

Ofwat’s approach in its most recent price control review (PR14) was more closely aligned to the PREMO approach. Ofgwat used an “outcomes-focussed approach”¹¹, and its framework was much less prescriptive than previous price controls and compared to Ofgem’s RIIO approach.

Ofwat defined¹²:

- “Outcomes are the things that society and customers value.”
- “Outputs are specific things that the companies deliver to [help to] achieve those outcomes.”

3.4.1 Outcomes

Ofwat did not prescribe the outcomes that businesses needed to deliver and there were no limitations or requirements on the number, form or depth of outcomes or outputs. Businesses had to formulate their own outcomes, in an approach aimed at providing businesses with greater flexibility to meet the needs of their customers. Businesses were expected to use outcomes as end policy goals, used to prioritise their operations. This is consistent with the Commission’s vision for PREMO.

3.4.2 Outputs

Once businesses had defined their outcomes, businesses had to develop outputs (also referred to as performance commitments), which were tied to each outcome and that could be used to track delivery. Again, businesses were given freedom to decide on many of their outputs, and were required to engage with their customers to develop these for each outcome. Businesses had to complete willingness to pay analysis in order to quantify customer expectations and priorities. Ofgwat set some outputs in key areas such as customer service¹³ and water quality and pollution incidents¹⁴.

11. http://www.ofwat.gov.uk/wp-content/uploads/2015/11/pap_pos201307finalapproach.pdf

12. http://ofwat.gov.uk/wp-content/uploads/2015/12/prs_inf1103fploutcomes.pdf

13. http://webarchive.nationalarchives.gov.uk/2015062409/http://ofwat.gov.uk/pricereview/pr14/pap_pos201307finalapproach.pdf – Page 71

14. <https://www.southernwater.co.uk/Media/Default/PDFs/Water-2020-Customer-Engagement.pdf>

Ofwat told businesses that outputs would need to be consistently measurable over time, and challenging enough to encourage businesses to improve their performance levels.

3.4.3 Incentives for delivery of outputs

Ofwat also used an outcome delivery incentive (ODI) to incentivise businesses to achieve their proposed outcomes¹⁵. This set a financial reward or penalty for delivery of

each output. Some measures also include a reputational incentive. For most businesses, this means that adjustments will be aggregated over the five-year regulatory period, with a financial adjustment applied in the Price Review for 2019¹⁶. The Commission has not proposed any additional financial incentives for the delivery of outputs, other than the up-front incentive linking a business's return on equity to the development and delivery of outputs.

Example 4: UK water business

Thames Water (TW) began its engagement process in early 2012 – over 30 months before the price control period began. They used stakeholder engagement to develop a draft list of potential outcomes. They then presented this to their Consumer Challenge Group to review and refine.

TW set out five overall outcomes:

1. We will provide a safe and reliable water service that complies with all necessary standards and is available when our customers require it.
2. We will demonstrate to our customers and stakeholders that they can trust us, that we are easy to do business with, and that we care.
3. We will provide the level of service our customers require, in the most economic and efficient manner, to ensure that bills are no more than necessary.
4. We will limit our impact on the environment and achieve a socially responsible, sustainable business for future generations, including reducing levels of leakage.
5. We will provide our customers with easy-to-use contact options.

Examples of outputs

Properties experiencing chronic low pressure.

- The number of properties at the end of the reporting year, which are suffering from the pre-defined measure of Chronic Low Pressure.

Reduce the amount of phosphorous entering rivers.

- The amount of phosphorous removed from rivers through the final National Environment Programme schemes by the end of 2015-20, measures as kilograms per day. Financial incentive, with potential for reward or penalty.

15. <http://www.bournemouthwater.co.uk/Uploads/Docs/economic%20regulation-competition/2015%20documents/ODIs%20Explanation.pdf>

16. http://www.ofwat.gov.uk/wp-content/uploads/2015/10/pap_tec201507pr14reconrule.pdf

Example 5: UK water business

AffinityWater (AW) undertook a consumer engagement campaign that resulted in 12,500 customer responses. This included a written consultation, face to face and telephone surveys, deliberative forums, online panels and focus groups. Thereafter, AW identified four key expectations or outcomes, which it used to define its submission:

1. Making sure both customers and the environment have enough water;
2. Supplying high quality water you can trust
3. Minimising disruption to you and your community
4. Providing a value for money service

Following engagement, AW aligned outputs to the customer outcome priorities.

Reduce leakage by 14 per cent or 27m litres per day

AW increased this from its original target of 10 per cent to reflect the importance placed on it by customers.

Reduce average water use by 7 per cent

AW slowed its proposed pace of investment, to reflect customer feedback, and instead targeted universal metering for 280,000 customers in the most water-stressed communities.

Compliance with water quality standards

Maintain the high quality of water through investment in treatment works, sampling across the network and preserving quality of water sources. New commitment measures were introduced by AW in response to the customer feedback.

Number of burst mains

Invest in network to maintain current service levels. This was amended to focus on maintaining the stability of the network to provide a reliable service, based on feedback.

AW was awarded Enhanced Status by Ofwat for PR14.

4. The Assessment Framework

4.1 Introduction

The assessment framework proposed by the Commission will require businesses to complete a self-assessment of their price submissions against the four key PREMO elements:

Risk, **E**ngagement, **M**anagement accountability and **O**utcomes. Each business will accompany their price submission to the Commission with the results of their self-assessment. The result will be a self-rating of either: “Leading”, “Ambitious”, “Standard” or “Basic”.

The Commission will then complete an assessment of each submission against the same four elements, and produce its own view of the appropriate rating for each business. The results of the assessment will determine the returns that each business will be allowed to recover for the regulatory period.

4.2 What we were asked by the Commission

In meeting the scope of this engagement, the Commission asked KPMG to answer four questions related to each element of the PREMO framework:

- What questions should guide the assessment under each element of PREMO?
- What is the scoring approach?

- How should the business self-assess?
- How should the Commission assess each business’ pricing submission (both individually and comparatively)?

4.3 Our recommendations

The following section details our recommendations regarding the guiding questions for assessing each of the PREMO elements.

4.3.1 What questions should guide the assessment under each element of PREMO?

The PREMO framework will be used to classify a pricing submission against four different levels of “ambition”. The rating assigned will determine the returns that each business can earn. These ratings are:

- “Leading”, a water businesses must propose a step change in proposed outcome commitments, controllable costs or both, thus setting the water business apart from its peers. It would demonstrate that customer engagement had heavily influenced the business’s proposals, and show that the business had accepted risk on behalf of customers.
- “Ambitious”, a water business would propose significant improvements in outcome commitments, controllable costs or both. It would demonstrate

that customer engagement had heavily influenced the business’s proposals, and show that the business had appropriately allocated risk between itself and customers.

- “Standard”, a water business would need to detail, justify and validate the inputs, activities and associated costs in its pricing submission, as being consistent with current good practice in the Victorian water sector. This would include early, broad and targeted engagement on issues important to customers; agreement to a set of outcome commitments; explicitly meeting the requirements of the Commission’s Guidance Paper; appropriately allocating and managing risk; and ensuring the quality of all information and documentation submitted to the Commission.
- “Basic”, a water business would propose outcome commitments of a lesser standard, or increasing controllable costs. It may not reflect an expansive customer engagement process, or make unreasonable assumptions about risk and its allocation. It may contain errors in fact, inconsistent data or unsubstantiated forecasts.

We recommend that the Commission be very clear to customers, that a Basic submission must at its minimum level, provide a safe and reliable service for its customers.

We have set out below our recommended guiding questions for each of the four key PREMO elements.

Table 4: PREMO guiding questions

Outcomes



- Has the business provided evidence that the outcomes proposed have taken into account the views, concerns and priorities of customers?
- Has the business provided sufficient explanation of how the outcomes it has proposed align to the forecast expenditure requested?
- Has the business proposed outputs to support each of its outcomes, which are measurable, robust and deliverable?
- Has the business justified that the outputs it has proposed align to the outcomes?
- Has the business demonstrated a reporting and stewardship process to measure performance against each outcome and to inform customers?

Management



- Has the business provided evidence that there is senior level, including Board level, ownership and commitment to its submission and its outcomes?
- Has the business demonstrated how its proposed prices reflect only prudent and efficient expenditure?
- Has the business provided sufficient justification of the quality of the submission, including the quality of supporting information on forecast costs?

Engagement



- Has the business detailed and justified alignment of its customer engagement process with the IAP2 Public Participation Spectrum?
- Has the business demonstrated that it has engaged with a broad range of customers in developing its submission?
- Has the business demonstrated that it has engaged with its customer about a range of issues relating to its submission?
- Has the business explained how it decided when to engage with its customers?
- Has the business explained how its engagement with customer has influenced its submission?

Risk



- Has the business demonstrated a robust process for identifying risk, and how it has decided who should bear these risks?

These guiding questions heavily leverage from the assessment criteria used in Ofwat’s and Ofgem’s regulatory frameworks, the detail of which is provided in Appendix 3.

4.3.2 Completing a self-assessment

The following table provides:

- Guiding questions to assess a pricing submission against each of the “REMO” elements. Assessment against P is detailed separately in section 5.3.1 because unlike the REMO elements, the Performance element contributes to an ex post assessment of the implementation of the proposals contained within a pricing submission;
- Examples of the types of high level actions a business could take that would be consistent with a “Standard” rating under each REMO element. These examples are intended to provide guidance


only and do not comprise a “tick-the-box” checklist of what a business needs to do to achieve a standard rating for each element of REMO. This form of checklist would not provide appropriate incentives for businesses to put forward their best submissions, nor would it provide the Commission with flexibility in undertaking a comparative assessment of all submissions.

A more complete list of what might represent a “Standard” price submission is provided in the *PREMO Assessment Tool* (the Assessment Tool). We have provided examples here only to provide a high level description of our proposed assessment framework.

The Assessment Tool also includes guiding examples on what may constitute “Leading”, “Ambitious”, and “Basic” price submissions. It is the main resource that businesses should use to undertake their self-rating.

We have provided more guidance on the features of a price submission with a “standard” rating, as this rating is intended to represent what is expected of a well-run water business that continues to seek to minimise cost, and deliver improving customer value. Further, a standard rating will earn a return on equity commensurate with current good practice in the Victorian water sector. All businesses should seek, as a minimum, to achieve a standard rating.

Table 5: REMO assessment guiding questions and examples of actions consistent with a “Standard” rating

PREMO element	Guiding questions	Examples of a “Standard” submission
Outcomes 	<ul style="list-style-type: none"> • Has the business provided evidence that the outcomes proposed have taken into account the views, concerns and priorities of customers? • Has the business provided sufficient explanation of how the outcomes it has proposed align to the forecast expenditure requested? • Has the business proposed outputs to support each of its outcomes, which are measurable, robust and deliverable? • Has the business justified how the outputs it has proposed align with the outcomes? • Has the business demonstrated a reporting and stewardship process to measure performance against each outcome and to inform customers? 	<ul style="list-style-type: none"> • The outcomes proposed generally reflect customer preferences and priorities revealed through engagement. • In any instances where outcomes proposed are not consistent with customer views, the business has justified why this is so, within its submission. • The outcomes proposed are broadly consistent with existing levels of service provided to customers. • The business has mostly defined outcomes in ways that reflect the customer service experience (See Chapter 3). • The business has committed to and described a process for monitoring and reporting to customers, within period performance against outcomes.

PREMO element Guiding questions

Management



- Has the business provided **evidence** that there is senior level, including Board level, ownership and commitment to its submission and its outcomes?
- Has the business **demonstrated** that its proposed prices reflect only prudent and efficient expenditure?
- Has the business provided sufficient **justification** of the quality of the submission, including the quality of supporting information on forecast costs?

Examples of a “Standard” submission

- The senior executive team and Board of Directors acknowledge and can attest, (e.g. through some form of “Responsibility Statement”, or a statutory declaration), that it has undertaken appropriate internal procedures to assure themselves of the quality and accuracy of their price submission.
- The price submission addresses all requirements specified in the Commission’s Guidance Paper.
- The price submission contains no material or obvious errors or omissions.
- The price submission assumes productivity improvements built into forecast expenditure, at a rate at least equivalent to the Commission’s one per cent controllable operating expenditure efficiency hurdle (used in 2013 water price review).
- The business has sought to absorb the impact of any “cost push ins”

Engagement



- Has the business **detailed** and **justified** alignment of its customer engagement process with the IAP2 Public Participation Spectrum?
- Has the business **demonstrated** that it has engaged with a broad range of customers in developing its submission (Form)?
- Has the business **demonstrated** that it has engaged with its customers about a range of issues relating to its submission (Content)?
- Has the business **explained** how it decided when to engage with its customers (Timing)?
- Has the business **explained** how its engagement with customers has influenced its submission?

- The business demonstrates that engagement has occurred on matters that customers reveal are the most important to them.
- A business demonstrates that engagement was undertaken early, prior to locking in key strategies and priorities.
- A business demonstrates that the business re-tested its position and proposals with customers as it developed its price submission.
- The form of customer engagement is justified as being fit for purpose given the content and circumstances facing the business and its customers.

Risk



- Has the business **demonstrated** a robust process for identifying risk, and how it has decided who should bear these risks?

- The business meets the requirements of the Statement of Obligations and the Commission’s Guidance Paper in relation to risk.
- The business can demonstrate compliance with risk standards specified in the Statement of Obligations, such as ISO 31000.
- The unit rates used to evaluate projects and options reflect recent historical trends, and/or independently verified market forecasts.
- The business can demonstrate that it has thoroughly evaluated the feasibility of commencement and completion dates for major projects.

Within this table, we have highlighted key words such as “explain”, “justify”, “demonstrate”, “detail”, “evidence” etc. Whilst the answers to these questions may be binary (e.g. “yes” or “no”), each business will need to explain, within its price submission and supporting documents submitted to the Commission, how it has come to this conclusion. It will not be good enough to tick each box and assume a leading or ambitious rating. Each business should be able to demonstrate the basis for its answer. The Assessment Tool provides the guidance to businesses to undertake their self-rating.

Application of the guiding questions

To achieve an overall standard rating, a water business would need to detail, justify and validate the inputs, activities and associated costs in its pricing submission, as being consistent with current good practice in the Victorian water sector. It must have:

- Defined a set of outcomes with its customer base through early, broad and targeted engagement on issues related to customer value; and
- Submitted a set of proposals that:
 - Seek to minimise cost and price impacts on customers;
 - Transfer risk to the party best placed to manage it; and
 - Have been through a rigorous internal assessment process to ensure completeness, accuracy, consistency, robustness and validity of all information and documentation submitted.

A response that does not provide this information will result in a business risking a basic rating, and/or moving into the “red zone”¹⁷, which may result in a business being required to re-submit its submission, and/or receiving a shorter regulatory period.

The Assessment Tool details the requirements of a standard rating under each element of REMO (i.e. consistent with good practice in the Victorian water sector) and the additional requirements to be rated “ambitious” or “leading”, or indeed the risks of being downgraded to “basic”. It is not intended to be the only solution, as a business could achieve higher, and or lower ratings in some categories and still achieve a standard rating under the proposed overall scoring approach. Similarly, our examples are “stand-alone” and are not designed to imply a package of answers to be graded as standard under the relevant questions.

Appendix 1 provides more detailed sub-questions that each business should consider, prior to completing its self-assessment, and Appendix 2 provides detail of the UK precedent supporting our proposed assessment framework.

17. Essential Services Commission, 2016, *A new model for pricing services in Victoria’s water sector, Position Paper*, May.

To achieve an overall ambitious or leading rating, a business would need to:

- Propose an ambitious set of outcomes decided by customers, and to undertake a process that allows customers to influence every aspect of its pricing submission, including prices and expenditure;
- Submit a set of proposals that:
 - Reduce the cost of service delivery and reduce prices faced by customers;
 - Accept more risk on behalf of customers, whilst promoting effective financial management; and
 - Demonstrate a rigorous internal assessment process through a complete, accurate and consistent set of documents and supporting information that are independently validated and tested, and explicitly meet the requirements of the Commission and legislation.

We recommend that the Commission publishes its guiding questions that will apply to all businesses in advance, as well as the sub-questions (refer Appendix 1) to assist the businesses in undertaking a self-assessment for each element of REMO. We suggest that each business would address these sub-questions in its submission.

Businesses will need to consider how best to answer each question based on their understanding of what their customers want and need. **It will be critically important for a business to link its customer engagement with the service outcomes and other proposals contained within its pricing submission.**





4.3.2.2 Scoring approach

We recommend that the Commission requires each business to:

- Use a form of “traffic light” assessment of its submission against each PREMO element, scoring its submission using a rating of either Leading (green), Ambitious (yellow), Standard (amber) or Basic (red), by reference to the question described above; and
- Detail and justify its overall self-assessment based on this traffic light assessment, by addressing each of the guiding questions and sub-questions detailed for each element of PREMO.

An example of traffic light assessments of four different businesses is provided below. Section 4.3.2.3 provides detail of what these individual scores will mean to informing the overall score.

Table 6: Proposed scoring approach

Business	 Risk	 Engagement	 Management Accountability	 Outcomes
A				
B				
C				
D				

Leading
 Ambitious
 Standard
 Basic

Should the PREMO elements be weighted?

The following table details the four options the Commission could adopt in undertaking an overall assessment.

Table 7: Potential PREMO element weightings

Options	Pros	Cons
Same weighting for all elements.	<ul style="list-style-type: none"> Encourages businesses to focus on a submission that achieves the same standards for all elements. Requires the elements to be of equal importance. More fitting for a smaller number of high level assessment questions for each element – to avoid putting an undue burden onto businesses. 	<ul style="list-style-type: none"> Commission may find that some elements need greater weighting, such as engagement and outcomes.
Same weighting applies, but different levels of scrutiny for different elements.	<ul style="list-style-type: none"> Provides guidance for businesses, but allows the regulator to tailor its assessment depending on the evidence provided and the quality of information submitted. 	<ul style="list-style-type: none"> Can lead to complexity and differences in approach.
Different weighting for different elements.	<ul style="list-style-type: none"> Can ensure that priority areas are given more attention. Can allow businesses with resource restrictions to prioritise their submission on the key elements. 	<ul style="list-style-type: none"> Can lead to some elements getting minimal attention and focus
Commission makes overall assessment based on judgement. Element scoring used as a guide only.	<ul style="list-style-type: none"> Encourages companies to focus on producing a high quality, well justified, all-round pricing submission. Commission not constrained by a ‘tick the box’ exercise and can take an overall view of the quality of the submission. Allows a greater role for comparative assessment, to drive continual improvement and simulate competition between businesses. 	<ul style="list-style-type: none"> Less transparency over why a particular assessment was given, although this can be addressed by the Commission justifying and validating its assessment to the business. Could lead to uncertainty about what areas are more or less important. Could lead to some areas being covered and scrutinised less than they otherwise would be.

We recommend that the Commission does not set out in advance any formal weighting to be given to the PREMO elements. The guidance provided in this report, the Assessment Tool and Appendix 1, provides clarity for each business on the way in which a business's proposal for each PREMO element will be assessed.

Appendix 3 provides detail of Ofgem's and Ofwat's approaches to weighting their various criteria. Neither Ofgem nor Ofwat apply specific weightings to their assessment criteria.

4.3.2.3 How should an overall score be determined?

This section provides an example assessment of businesses' pricing submissions against REMO, using Table 5 above as an illustrative example.

The main options for completing an overall score are:

- **Across the board**

All elements must be rated at a level to be awarded an overall rating at that level.

As an example, in Table 6, business:

- A would be rated as Leading
- B would be rated as Standard
- C would be rated as Standard
- D would be rated as Basic.

This sets "the bar" at a higher standard than the other two approaches and does not take into account the relative significance of the different elements to a business's overall performance. It also could reduce incentives for a business to be Ambitious or Leading in other elements if for any reason it were not confident of achieving more than say Basic or Standard in any one element.

- **Average**

A business is allocated a rating based on its average score across the four REMO elements. These could score as follows:

- Leading 4
- Ambitious 3
- Standard 2
- Basic 1

A business would need to achieve an average score at least equal to a rating to achieve that rating.

As an example, business:

- A would be scored at an average of 4.00 and rated as Leading
- B would be scored at an average of 2.75 and rated as Standard
- C would be scored at an average of 3.50 and rated as Ambitious
- D would be scored at an average of 2.00 and rated as Standard.

This approach differs to the across the board approach in that it allows some lesser performance in some REMO elements to be compensated for by higher performance in others, but still requires a business to be Leading across all four REMO elements in order to achieve a Leading rating

- **Judgement**

The Commission has discretion to assess the overall rating of a submission. For example, Business B could be judged as rating anywhere between Standard and Leading depending on the Commission's judgement. This would allow the Commission to consider:

- Wider issues of relevance to each business's submission; and
- A comparative assessment of submissions by different businesses.

Wider issues for the Commission to consider

The Commission may want to take a wider view of each business and its submission, to sense check and provide confidence in its scoring of the submission under each PREMO element. This could include:

- Consideration of the track record of each business in delivering against previous commitments in previous price controls, as an indication of the reliability of the submission and the commitments proposed.
- Whether a business has complied with the PREMO process, including submitting high quality submissions and meeting all deadlines.
- Consideration of any recent and/or ongoing issues on customer related issues, such as current rates of customer complaints or compliance issues.

Comparative assessment

In addition to scoring each submission against each of the assessment elements, the Commission may also want to consider the comparative assessment of the submissions received.

- **Comparison within each rating level**

The Commission could choose to compare the overall ratings of each business against one another to check whether the distribution of outcomes is "sensible". For example, in addition to scoring a submission under each PREMO element, the Commission could compare all of the submissions self-rated as Leading.

- **Comparison within each assessment element**

The Commission could choose to compare each business's individual ratings within each element of PREMO. For example, the Commission could compare submissions rated as Leading in the Engagement assessment element.

Both Ofgem and Ofwat use the Price Review process as an opportunity to compare the businesses against one another, in order to drive a "competitive" approach and encourage continual improvement. Although neither Ofgem nor Ofwat specify a restriction on the number of businesses that can score the highest rating, in practice, these are given to only a small number of businesses in each control, if at all. Ofgem and Ofwat also publish the results of their assessments of each submission, clearly identifying the best (and worst) businesses. This can have a reputational incentive for businesses to improve their submission and achieve a better outcome in the current and future Price Reviews.

4.3.2.4 Our recommendations

The Commission has various options to consider when scoring the submissions. Our recommendations are that:

- For a "Leading" rating, submissions would need to score "green" in all four of the assessment elements at both self-assessment and Commission assessment. This is consistent with Ofgem's approach for deciding whether to fast-track any energy businesses. Ofgem restrict this to businesses scoring "green" across all elements.

- An average score is appropriate for those businesses that score a mix of ratings across the four REMO elements. For example, a leading rating would receive a score of 4, with a decrement of 1 for each subsequent lower rating. An arithmetic average would then be calculated across the REMO elements. This average would then be compared to the range of scores related to the overall rating (e.g. a score between 3 and 3.99 would result in an ambitious rating, a score between 2 and 2.99 would result in a standard rating, etc.). Where a rating is at the margins, the Commission could provide for within a period adjustment, as described in section 5.3.1.
- The Commission will want to apply its own judgement to the colour scores when deciding on the overall rating of the business. The Commission's final decision on each submission would take into account the quality of the submission against each assessment question, but the Commission will also want to consider:
 - The track record of each business in delivering against previous commitments and any ongoing customer related issues such as current rates of customer complaints; and/or
 - Comparative assessment, in comparing submissions against one another to encourage competition between businesses and to identify those submissions that truly demonstrate a leading approach.

We understand that the Commission will clarify that businesses will have to accept the final rating that they are given, and that appeal is not an option. That said, as part of its 2018 water price review, the Commission will publish a draft decision - this will include its views on the rating of a business's price submission. This may provide an opportunity for businesses to challenge the Commission's initial price submission rating.

5. Adjustments and monitoring performance

5.1 Introduction

It is important that a business not only presents a pricing submission with the highest level of ambition, but that it also delivers on its proposals within that regulatory period. To incentivise businesses to deliver on its promises, the regulatory framework can be designed to monitor performance and to potentially reward/penalise a business where it has exceeded/underachieved against its agreed outcomes and outputs.

Revenue (and therefore prices to customers) can be adjusted throughout the regulatory period to reflect levels of performance, risk and uncertainties not known at the outset of the price control and mechanical adjustments. In the UK energy and water regimes, there are quite complex methodologies for calculating and making these adjustments.

Under PREMO, each business will produce their submission which will set out a number of outcomes and outputs. Within the course of the regulatory period (currently ranging between three to five years), the Commission is likely to require evidence that a business is delivering against its outcomes and outputs. In the UK, energy and water businesses face onerous and detailed reporting requirements, involving comprehensive annual data collection

and reporting. The detail of these arrangements is provided in Appendix 4.

5.2 What we were asked by the Commission

In meeting the scope of this engagement, the Commission asked KPMG to answer three questions related to adjusting prices to consider within period performance:

- How should prices (returns) be adjusted for performance?
- How should prices be adjusted for uncertainty?
- How should performance be monitored?

5.3 Our recommendations

5.3.1 Adjusting prices to account for performance

There is a range of four options that the Commission could adopt in adjusting a water business's prices to reflect performance against its agreed outcomes and outputs:

- Within period adjustments;
- Log-up/log-down;
- Recovery; and
- No adjustment.

The following table details the pros and cons of each approach, based on our detailed knowledge of the frameworks adopted by Ofgem and Ofwat.

Table 8: Options for adjusting prices to account for performance?

Options	Pros	Cons
<p>1. Within period adjustment Annual adjustments for performance against annual incentives.</p> <p>(Consistent with Ofgem’s approach)</p>	<ul style="list-style-type: none"> • More immediate ‘signal’ to water businesses. • More immediate benefit (cost) to customers. • Smooth out peaks and troughs that may be experienced if incentives are settled at the end of the regulatory period. 	<ul style="list-style-type: none"> • Can result in a more complex regime and significant resource requirements for businesses and the regulator. • Weakens importance of strong and accurate pricing submission in the first place. • Leads to volatility in prices, with changes in every year.
<p>2. Log-up/log-down A business’s allowed revenue is adjusted at the end of the price control period, reflecting their performance against a range of incentives.</p> <p>(Consistent with Ofwat’s approach)</p>	<ul style="list-style-type: none"> • Less complex than annual adjustments. • Still provides a strong incentive for high levels of performance. 	<ul style="list-style-type: none"> • Could result in large rewards or penalties being awarded in one go (i.e. every five years). • Relies on data collated in each year being accurate, without an annual review of the data.
<p>3. Recovery Regulator can request that a business return some of the revenue they were allowed at the end of the review or possibly at a mid-period review. This would be triggered only if the regulator judges that a business has not delivered what they committed to do.</p>	<ul style="list-style-type: none"> • More proportionate approach, regulator would only intervene if a business had not delivered. • Puts burden for proving delivery onto the business. • Provides strong incentive for business to deliver. • Opportunity for poor performance to be addressed quickly. 	<ul style="list-style-type: none"> • Practicalities of recovery may be difficult, as revenue will already have been spent by the business. • Determining the appropriate level of recovery can
<p>4. No adjustments No adjustments due to performance incentives or any recovery.</p> <p>In the next price control period, a business’s previous performance is a major factor in the regulator’s assessment. This impacts the level of return on equity awarded.</p>	<ul style="list-style-type: none"> • Minimum complexity and therefore resource needed for regulator and businesses. • Emphasis placed on a strong pricing submission and detailed assessment of the submission. 	<ul style="list-style-type: none"> • Potential for a company to game the process by easing back outside of pricing submission periods. • Requires detailed assessment of past and forecast performance and submissions at the time of the Price Review. • May not provide a strong enough driver for delivery within the period – if there is no financial consequence.

Under the Commission's PREMO approach, a business's reward for proposing a leading or ambitious submission is a higher allowed return in the regulatory period. Businesses stand to gain more if the Commission agrees with their self-assessment, as the Commission will reduce the level of return awarded if a business's self-assessment rating is too high compared to the Commission's assessment.

Given the PREMO approach, upward adjustments are unlikely to be required or justified for Victorian water businesses as the "reward" is effectively provided up front. An exception to this may be where the Commission's overall rating falls just short of the business's self-assessment rating. For example, the Commission agrees with three of the individual ratings against EMO (leading), but determines a lower rating for R (ambitious), such that it takes the business's overall rating from one level of ambition (leading) down to another (ambitious, as a green rating is needed on all four elements).

If the business was able to demonstrate performance consistent with its self-assessment rating within the period, the Commission could then choose to reopen the control, and adjust the level of returns upwards for the rest of the regulatory period. This would provide an incentive for those businesses penalised for over-rating their self-assessment to continue to improve within the regulatory period.

There is potentially a stronger case for the Commission to be able to make a downward adjustment to returns based on under-performance. This would be triggered if there is evidence that a business is not delivering what it had promised to its customers in its submission. The Commission may not want to wait until the next review period to address this. In this case, the Commission could choose to decrease the level of returns allowed to that business for the rest of the period. The Commission could also consider, in exceptional cases, whether to recover the equivalent level of return that a business should not have been able to recover, given its performance record.

We would recommend that the Commission provide penalties for businesses, that allow recovery at the end of the regulatory period, for the difference between the rate of return determined at the outset of the regulatory period, and the rate of return that would have been determined, had the rating of the ambition of the submission been consistent with the actual level of performance. Any recovery applied would require very clear and explicit justification. A decrement can be applied to the revenue requirement in year one of the next regulatory period, such that a return is provided to customers immediately. We would recommend that the Commission only exercise this option where a business has clearly and consistently underperformed against its agreed outcomes and outputs.

Subject to the Commission's discretion, where the Commission's overall rating may fall just short of a business's self assessment, outlined on the prior page, would not recommend the provision of financial rewards for outperformance of the determined rating, as rewards are awarded up front through the setting of the level of return for each business. Additional rewards would result in "double treatment", which would not be in the interests of customers. As an example, a business may only seek to provide a basic/standard submission, in the knowledge that excellent performance within the period would allow them to recover the lost returns. It is important that businesses are incentivised to submit as high a quality pricing submission as possible, and thus be rewarded for such up front, but not retrospectively.

5.3.2 Adjusting prices to account for uncertainty

Within its 2013 Guidance Paper, the Commission approved a mechanism for managing uncertain or unforeseen events for the second regulatory period, including the hurdle it requires for a mid-period review¹⁸. We would not provide any recommended changes to the Commission's approach, other than to allow businesses to nominate these events within their submission and to clearly define the threshold hurdles for an adjustment to occur, such that there is greater certainty for trigger events during the regulatory period. This would allow the Commission to approve, or not approve these proposals. Any trigger events should be consistent with the Commission's requirements, as detailed in its 2013 Guidance Paper.

18. Essential Services Commission, Guidance Paper 2013 Water Price Review, p.19-21.

5.4 Performance monitoring and reporting

There are three options for dealing with uncertainty during the regulatory period:

- Annual data submission;
- Annual public reporting; and
- No regular reporting.

The pros and cons of each option are detailed in the following table.

Table 9: Options for monitoring and reporting performance

Options	Pros	Cons
<p>1. Annual data submission Annual submission of a number of sets of data. This data can be used to assess performance against the submission.</p>	<ul style="list-style-type: none"> • Regulator receives a substantial amount of data with which to make a robust assessment of performance. • Business required to keep accurate and timely records, to allow assessment of performance. • Encourages businesses to focus on performance in each year, as well as at the time of submission. 	<ul style="list-style-type: none"> • Significant administrative burden for regulator and businesses. • Information may not all be necessary, particularly for businesses performing well.
<p>2. Annual public report Annual 'customer friendly' report explaining what the business has delivered over the past year.</p>	<ul style="list-style-type: none"> • Businesses continue to engage with customers and stakeholders outside of pricing submissions. • Regulator receives information which it can use to assess performance, but this is more limited than a formal annual data submission. • Maintains focus for businesses on customers, rather than the regulator. 	<ul style="list-style-type: none"> • Places annual cost and resource burden on businesses. • Annual report may not be read by many customers, and so may be of little value to them.
<p>3. No reporting between pricing submissions. Businesses would only be required to submit data as part of their submission. The regulator could request information from a business at any time, if it had a concern or query.</p>	<ul style="list-style-type: none"> • Minimises administrative burden between pricing submissions for both regulator and businesses. • Allows Commission to determine when to ask for information. 	<ul style="list-style-type: none"> • Regulator may be unclear on how well a business is performing during the regulatory period without regular reporting. • It may be more difficult for the regulator to identify, and so act on, any performance issues. This could mean that issues become worse, rather than being addressed early.

Given the focus of the Commission on incentivising a business to agree a set of outcome commitments with its customers through engagement, the concept of not reporting performance against these outcomes during a regulatory period would appear impractical and against the principles that underpin PREMO. As such, we would strongly recommend this approach not be considered.

The Commission currently collects and reports performance information consistent with the indicators and definitions outlined in the Commission's performance reporting framework. Through this process, we would recommend the Commission collects annual output data from each business (consistent with that specified in the pricing submission and agreed with customers), including a qualitative narrative. This should be supplemented by the collection of actual expenditure by expenditure category.

We recommend that each business prepares an annual report for their customers that outlines its performance against what it has promised, in an accessible and

customer-friendly way. Good examples of such reports are available from the UK experience. Whilst the Commission should not prescribe a method of reporting, it could provide examples that it feels appropriate (such as through their websites, and/or through the provision of bill inserts). This would involve limited resource and time commitments from each business and the Commission. However, this would maintain an ongoing drive to deliver against the submission and a potential reputational incentive, both in terms of comparative performance between businesses. Businesses that produce a high quality annual report, that is valuable for customers and the Commission, could use this as evidence of their engagement activity in the next price review.

The Commission should require the water businesses to publicly report the same data, without prescribing the method for reporting. The Commission would also retain the option to request data from any of the businesses, at any time during the regulatory period and the ability to audit performance data provided.

Inherent Limitations

This report has been prepared as outlined in the Introduction chapter. 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.

KPMG has 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 Introduction chapter and for the Essential Services Commission's information, and is not to be used for any other purpose.

This report has been prepared at the request of the Essential Services Commission in accordance with the terms of KPMG's engagement contract dated 24 June 2016. Other than our responsibility to the Essential Services Commission, 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.

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