



Essential Services Commission

Implementing PREMO

Detailed sub-questions
and lessons from the UK

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Appendix 1

Guidance sub-questions to support a business’s self-assessment

In order to enable a business to adequately answer each of the guiding questions detailed in Section 4.3.2 of *A practical guide for implementing PREMO*, we have proposed a set of more detailed sub-questions to guide each business in undertaking an accurate self-assessment.

1.1 Outcomes

Table 1. Guidance sub-questions to support a business’s self-assessment of outcomes

Guiding questions	Sub-questions a water business could consider
Has the business provided evidence that the outcomes proposed have taken into account the views, concerns and priorities of customers?	<p>Engagement input</p> <p>Has the organisation developed a set of outcomes that reflect customer preferences and priorities revealed through engagement?</p> <p>Where outcomes proposed are not consistent with customer views, has the business justified why this is so within its submission?</p>
	<p>Cost/outcome trade-off</p> <p>Has the business undertaken an exercise to determine the willingness to pay/trade of its customers for changes in customer service levels?</p>
	<p>Information</p> <p>Has the business provided customers with information regarding the cost impacts of delivering the proposed outcomes?</p>
Has the business provided sufficient explanation of how the outcomes it has proposed align to the forecast expenditure requested?	<p>Alignment with expenditure</p> <p>Has the business clearly documented how its proposed operating and capital expenditure programs are consistent with the outputs proposed?</p> <p>Has the expenditure profile changed (where necessary) to reflect customer priorities?</p>
	<p>Clearly defined</p> <ul style="list-style-type: none"> • Has the business defined outcomes that reflect the customer service experience, such that they are: • Measurable (what is the metric by which success can be measured?); • Time limited (when will the outcome be delivered?); and • Allocated to a responsible party (clear ownership within the business of delivery)?
Has the business proposed outputs to support each of its outcomes, which are measurable, robust and deliverable ?	

Guiding questions

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?

Sub-questions a water business could consider**Customer input**

Has the business involved customers in the development of the outputs it is proposing to deliver?

Outcome delivery

Has the business proposed a change in the outputs required to meet the agreed outcomes (e.g. improvement, maintenance or decline)?

Performance monitoring

Has the business committed to and described a process for monitoring and reporting to customers, within period performance against outcomes?

1.2 Management

Table 2. Guidance sub-questions to support a business's self-assessment of management accountability**Guiding questions**

Has the business provided **evidence** that there is senior level, including Board level, ownership and commitment to its submission and its outcomes?

Sub-questions a water business could consider**Senior executive and Board sign-off**

Has the senior executive team and Board of Directors acknowledged and attested, 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?

Has leadership considered:

- The consistency of information provided within the submission and its supporting documents;
- The accuracy of information provided within the submission and its supporting documents;
- The assumptions contained within the submission and their appropriateness; and
- Appropriate project governance arrangements and processes?

Has the business ensured its price submission is 'internally consistent' – demonstrating alignment between its different elements (e.g. there is consistency between the outcomes proposed, and demand and expenditure forecasts)?

Timelines

Has the price submission and supporting information been provided to the Commission by the time requested?

Guiding questions

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?

Sub-questions a water business could consider

Expenditure

Has the Board and senior executive leadership team sought to adopt assumptions and methods that minimise the cost of service delivery, and/or minimise prices faced by customers?

Has the financial template provided to the Commission been completed (with no missing information), and is it consistent in every respect with the written price submission?

Has the business assumed 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)?

Has the business sought to absorb the impact of any "cost push ins"?

Has the business explained mitigation strategies for any customers or groups of customers that may experience a price shock?

Baseline

How has the business established the baseline that underpins its forecasts?

Trend

In addition to productivity improvements, has the business considered price growth and output growth?

Are forecasts consistent with historical trends?

Compliance with regulation and legislation

Has the price submission addressed all requirements specified in the Commission's Guidance Paper?

Has the business developed a set of proposals that align with the delivery of documented Government policy, technical and regulatory requirements (e.g. the Water Industry Regulatory Order, relevant legislation etc.)?

Justification

Has the business prepared clearly documented evidence that supports its assumptions?

Has the business retained supporting documentation to justify its proposals, with ongoing access available to the Commission?

Methods

Has the business adopted forecasts for expenditure and demand based on sound methodologies and assumptions?

Business cases

Has the business prepared business cases and justification for all major projects and capital programs, including evidence that a range of options have been considered?

Validation

Has the business sought to validate its forecasts?

Presentation

Is the price submission free of error in compilation and calculation?

1.3 Engagement

Table 3. Guidance sub-questions to support a business's self-assessment of engagement

Guiding questions	Sub-questions a water business could consider
<p>Has the business detailed and justified alignment of its customer engagement process with the IAP2 Public Participation Spectrum?</p>	<p>IAP2 Public Participation Spectrum</p> <p>Has the business identified where on the IAP2 Public Participation Spectrum (the Spectrum) its overall engagement strategy lies?</p> <p>Has it justified the basis for why it has adopted the engagement activities consistent with this positioning on the Spectrum?</p>
<p>Has the business demonstrated that it has engaged with a broad range of customers in developing its submission (Form)?</p>	<p>Breadth</p> <p>Has the organisation engaged with a reasonable cross-section of its customer base (e.g. people with disabilities, regional communities, pensioners, single mothers, culturally and linguistically diverse groups such as refugees and newly arrived migrants, Aboriginal communities etc.)?</p>
<p>Has the business demonstrated that it has engaged with its customers about a range of issues relating to its submission (Content)?</p>	<p>Fit-for-purpose</p> <p>Has the business justified the form of customer engagement as being fit for purpose given the content and circumstances facing the business and its customers?</p>
<p>Has the business demonstrated that it has engaged with its customers about a range of issues relating to its submission (Content)?</p>	<p>Content</p> <p>Has the business demonstrated that engagement has occurred on matters that customers reveal are the most important to them?</p> <p>Was engagement designed to illicit a certain response, or did the business openly seek customers to raise their issues?</p> <p>Did the business provide a reasonable level of data to facilitate customers providing informed feedback?</p> <p>Did the business discuss the impacts of the outcomes it was seeking to deliver?</p>
<p>Has the business demonstrated that it has engaged with its customers about a range of issues relating to its submission (Content)?</p>	<p>Ease of understanding</p> <p>Has the organisation been able to communicate complex challenges and information in plain English?</p> <p>Has the business demonstrated that the information provided to customers was appropriate given the purpose, form and content of customer engagement?</p>
<p>Has the business explained how it decided when to engage with its customers (Timing)?</p>	<p>Timing</p> <p>Has the business demonstrated that engagement was undertaken early, prior to locking in key strategies and priorities?</p>
<p>Has the business explained how it decided when to engage with its customers (Timing)?</p>	<p>Ongoing</p> <p>Has the business sought to implement an ongoing engagement process during the price review and beyond (e.g. during the next regulatory period)?</p>

Guiding questions

Has the business **explained** how its engagement with customers has influenced its submission?

Sub-questions a water business could consider

Alignment

Does the price submission describe what was learned from customer engagement, and how this influenced its proposed outcomes, expenditure (composition and level) and prices?

Has the business developed a submission that addresses feedback provided by customers through engagement?

Where relevant, what is the explanation for any variations?

Support

Has the business demonstrated that it has re-tested its position and proposals with customers as it developed its price submission?

Feedback

Has the organisation reported back to its customers the outputs of its engagement process?

Have customers had the opportunity to critique how their feedback was used to develop the price submission?

Process

Has the business clearly documented the engagement process it undertook, and the lessons learned from that engagement?

1.4 Risk

Table 4. Guidance sub-questions to support a business's self-assessment of risk

Guiding questions

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

Sub-questions a water business could consider

Risk assessment approach

Has the business met the requirements of the Statement of Obligations and the Commission's Guidance Paper in relation to risk?

Has the business demonstrated compliance with risk standards specified in the Statement of Obligations, such as ISO 31000?

Does the organisation have a well-developed, detailed risk assessment process built into its governance arrangements that reflects good industry practice?

Does the business undertake appropriate cost/risk trade-offs?

Has the business considered the impacts of its risk management approach on its financial sustainability?

Project contingency

Can the business demonstrate rigorous probability analysis that can be independently replicated, to support project costs with contingency allowances that have no less than a 50% probability of exceedance?

Guiding questions**Sub-questions a water business could consider**

Unit rates

Do unit rates used to evaluate projects and options reflect recent historical trends, and/or independently verified market forecasts?

Capital delivery

Has the business demonstrated that it has thoroughly evaluated the feasibility of commencement and completion dates for major projects?

Has the business sought to balance network design standards and cost?

Form of price control and tariffs

Has the submission sought to appropriately balance revenue and cost risk between the business and its customers, without materially impacting on price stability?

Financial viability

Can the business support its assessment of financial viability by reference to cash flow projections and independent benchmarks (e.g. credit rating metrics)?

Expenditure forecasting

Has the business considered the ability to undertake efficient capex-opex trade-offs (e.g. an increase in opex is less than the costs of the avoided capex)?

Demand assumptions

Has the business sought to understand current trends in demand and the impact of investment in water efficiency and pricing?

How has the business considered the impact of climate on demand?

How has the business determined (and adjusted where necessary) the base year that underpins its forecast?

Demand management

Has the business actively sought to encourage demand management across its network?

Length of the regulatory period

Has the business proposed a term that allows them to best manage their business risks?

Uncertainty mechanisms

Has the business sought to identify and separate exogenous events that would impact the delivery of services?

Appendix 2

Assessment frameworks in the UK

2.1 Assessment criteria and scoring methodologies

Like the Commission, both Ofgem and Ofwat require each business to develop a price submission (known as a business plan) that meets a set of criteria that is set out in advance. Both regulators will assess each business's submission against this criteria, and use this to determine both the level of revenue that each business can recover and the returns it

can expect to achieve. Both Ofgem and Ofwat use a simple approach to publishing their scoring of each submission. This is summarised in the table below. Further details on the assessment criteria and scoring approach for Ofwat and Ofgem are included in the remainder of this appendix.

Table 5. Summary of assessment criteria and scoring process in the UK

Regulator	Assessment criteria	Scoring the submission
Ofgem	<ul style="list-style-type: none"> • Process • Outputs • Resources – costs • Resources – financing • Uncertainty and risk 	<p>Traffic light assessment against each criterion:</p> <ul style="list-style-type: none"> • Green – Broadly acceptable; • Amber – Some further work required; and • Red – A considerable amount of further work required.
Ofwat	<ul style="list-style-type: none"> • Outcomes • Cost • Risk and reward • Affordability and financeability <p>Each criterion has a defined set of sub-criteria.</p>	<p>Rating of A-D applied to each sub-criterion¹:</p> <ul style="list-style-type: none"> • A – Exceeds expectations and provides exceptional evidence; • B – Robustly addresses expectations and provides sufficient and convincing evidence; • C – Does not have sufficient and convincing evidence. More information needed; and • D – Substantially more information needed. <p>Sub-criteria ratings are considered to determine an assessment for each criterion.</p> <p>Overall assessment considers the rating for each criterion to determine overall assessment result.</p>

¹ http://www.ofwat.gov.uk/wp-content/uploads/2016/03/pap_pos140404pr14enhanced.pdf

2.1.1 Ofgem assessment criteria

Ofgem publish assessment criteria in their strategy decision document. This advises the network companies of how Ofgem will assess their business plans (and therefore what they need to include in these).

The most comprehensive assessment criteria were issued for the latest price control for electricity distribution networks (known as RIIO-ED1)².

There were five criteria, each with a number of questions or sub-criteria.

Table 6. Ofgem assessment criteria³

Process: Has the DNO followed a robust process?

- Is the business plan clearly presented, with all key content included?
- Has the DNO engaged with stakeholders, and explained how this has influenced its business plan?
- Has the DNO submitted, and justified, all data tables and the Price Controls Financial Model (PCFM)?
- Does the business plan provide a strategy for long-term delivery?

Outputs: Does the plan deliver the required outputs?

- Has the business plan covered the outputs specified in the strategy decision or provided clear and compelling justification for any departures from the strategy decision?
- Has the DNO explained the resource implications for delivery of each output identified?
- Has the DNO explained how it will deliver outputs, and justified the output baseline/forecast?
- Has the DNO explained the quality of its existing outputs and secondary deliverable information (including information on asset health, criticality and asset risk) and how it plans to improve this information in future?

Resources (efficient expenditure): Are the costs of delivering the outputs efficient?

- Has the DNO demonstrated that cost projections are efficient?
- How does the plan compare with others/does it reflect wider best-practice?
- Has the DNO demonstrated that their financial costs are efficient (e.g. through market-testing)?
- Has the DNO explained cost projections in context of historical performance?
- Has the DNO demonstrated a consideration of alternative approaches to achieving value for money in the delivery of its outputs?
- Has the DNO clearly linked its expenditure to relevant outputs and secondary deliverables?

Resources (efficient financing): Are the proposed financing arrangements efficient?

- Does the business plan conform with the financial policies specified in the strategy, are any departures well-justified?
- Has the DNO provided evidence that financial costs are efficient?
- Is the data in the plan consistent and has the DNO explained cost projections in the context of historical performance?

Uncertainty & risk: How well does the plan deal with uncertainty and risk?

- Has the DNO clearly articulated the key uncertainties it faces and considered how it will address them (e.g. including uncertainty mechanisms)?
- Has the DNO considered risk and how to mitigate those risks?

² Ofgem, [Network regulation – the RIIO model](#)

³ [Strategy decision for the RIIO-ED1 electricity distribution price control Business plans and proportionate treatment](#) (p15-16), Ofgem, March 2013

2.1.2 Ofgem scoring approach

For assessing the business plans, Ofgem adopted a traffic light assessment process giving a red, amber, or green rating for each of the five criteria outlined in Table 6.

Green = The company’s plans against the specific criterion are broadly acceptable without the requirement for further (detailed) analysis.

Amber = Areas where Ofgem consider some further work is required to produce an acceptable business plan.

Red = Areas where Ofgem consider a lot of work will be required to produce acceptable proposals in the business plan⁴.

Note that this traffic light assessment is made at the initial review of business plans prior to the fast tracking decision, which is an important part of the RIIO process. To be fast tracked companies had to be green across all five criteria.

Table 7 shows how each of the six electricity distribution network companies were assessed. Note that Western Power Distribution (WPD) were assessed as ‘green’ across all five assessment criteria and were therefore fast tracked at this stage.

Table 7. Traffic light assessment of electricity distribution network business plans (initial assessment pre-fast tracking)

DNO Group	Licensee	Process	Outputs	Resources – efficient costs	Resources – efficient finance	Uncertainty and risk
Western Power Distribution	WMID	Green	Green	Green	Green	Green
	EMID	Green	Green	Green	Green	Green
	SWALES	Green	Green	Green	Green	Green
	SWEST	Green	Green	Green	Green	Green
Electricity North West Ltd	ENWL	Green	Green	Amber	Green	Green
Northern Powergrid	NPgN	Green	Green	Amber	Green	Green
	NPgY	Green	Green	Amber	Green	Green
UK Power Networks	LPN	Green	Amber	Red	Green	Green
	SPN	Green	Amber	Amber	Green	Green
	EPN	Green	Green	Red	Green	Green
SP Energy Networks	SPD	Amber	Red	Red	Green	Amber
	SPMW	Amber	Red	Red	Green	Amber
SSE Power Distribution	SSEH	Green	Red	Amber	Green	Red
	SSES	Green	Amber	Amber	Green	Red

⁴ [Assessment of the RIIO-ED1 business plans](#) (p9), Ofgem, November 2013

2.1.3 Ofwat assessment criteria

The Ofwat methodology and expectations document published in July 2013, gave a final description of the methodology and assessment criteria used to assess submissions for the PR14 price control.

This document proposed the key criteria and methodology for the PR14 assessment, giving companies five months to finalise business plans which were to be submitted in December 2013.

Ofwat assess business plans based on a set of four key overarching criteria:

- Outcomes;
- Costs;
- Risk and Reward; and
- Affordability and Financeability.

Table 8. Ofwat assessment criteria

Outcomes – Ensuring outcome commitments must reflect what customers want and value

- Has the company engaged in effective consumer and stakeholder engagement and presented robust willingness to pay (WTP) information to justify the proposals within their business plan?
- Has the company given adequate assurance that performance commitments are consistent with requirements, with a fair and robust framework?
- Are the Outcome Delivery Incentives for the specific water company appropriate, consistent with consumer interest and do they fully account for other regulatory incentives?

Costs – The costs, for both wholesale and retail businesses, associated with delivering the company's proposed outcomes, are totex based

- Are wholesale costs deemed efficient and has evidence been provided which warrants a change in the proposed cost modelling methods by Ofwat for this specific company?
- How clearly and appropriately has the company currently, and previously, allocated Retail Costs between areas?
- Are adjustments to average cost to serve (ACTS) justifiable and evidenced appropriately?

Risk and Reward – How the company's proposals balance risk and the rewards for bearing those risks between consumers

- Has the company provided sufficient evidence to allow Ofwat to analyse company and consumer risks, and are the proposed risks appropriate?
- Are the proposed returns to the company within the business plan appropriate based on the level of risk undertaken by the company?

Affordability and Financeability – How the company's proposals balance affordability for customers and financeability for the company

- Has the company proposed acceptable retail and net margins?
- Will the company be able to adequately finance its proposals and will revenues allow for sufficient self-financing in the future?
- Has the company evidenced that they proposals are affordable over the price control period and over a longer term period?

⁵ http://www.ofwat.gov.uk/wp-content/uploads/2015/12/pap_pos201307finalapproach.pdf

In addition to these assessments, Ofwat applied additional considerations to proposals in their entirety. These additional considerations assist in deciding the overall levels of scrutiny that proposals are placed under, and also remedy outcomes from the previous price control.⁶

Table 9. Ofwat’s additional considerations

Additional considerations – Board approval and past performance

- To what extent has Board approval been given to companies’ constituent business plans, as well as to support data.
- How fairly do the company’s proposed adjustments to 2015-20 price controls reflect its performance in 2010-15?

Although Business Plans are assessed in isolation, if a company performed poorly over the previous price period, it was expected to put forward considerable supporting evidence to justify allowances within its PR14 proposals.

2.1.4 Ofwat scoring approach

The Ofwat scoring and assessment system is cumulative, starting at the smallest scale assessment and escalating to form an overall Business Plan assessment.

The four assessment criteria are each in turn assessed using a pre-determined set of Test⁷ and Test Sub-Criteria. Assessments are carried out on both a company level and for each element of a company’s business plan (household retail, non-household retail, water wholesale and wastewater wholesale), where appropriate.

Sub-criteria for each Test are assessed using a four point scale (A, B, C and D). These sub-criteria are combined to form an overall score for each Test on a per-element basis. The guidelines for deciding the score for each of the sub-criteria is unique, and based on a variety of specific considerations.

Additionally, the criteria used to amalgamate the (A – D) score for each overarching Test is also Test specific. Each Sub-Criterion and Test are finalised with their own A – D rating for each appropriate element.

2.2 Outcomes

In the UK the two regulators take slightly different views of what companies should set out. The energy regulator Ofgem expects network companies to set out what outputs they will deliver, which are quite specific measures of performance, grouped into six categories: safety, environment, customer satisfaction, connections, social obligations, and reliability.

In water, Ofwat wanted an outcomes based approach to company business plans for the PR14 price control. Although some specific technical output requirements are prescribed to companies, such as reductions in leakage levels, a significant degree of autonomy is given to individual water companies to formulate their own commitments and incentive mechanisms, to remedy issues highlighted as important through consumer engagement.

2.2.1 Ofgem – outputs

The **O** in **RIIO**, outputs are an important part of the energy regulation framework in the UK. The outputs framework comprises two categories⁸:

Primary Outputs which make a material contribution to the outcomes that Ofgem and the network’s stakeholders are seeking. The outputs are grouped into six categories⁹:

- Safety
- Customer service
- Environment
- Connections
- Social obligations
- Reliability and availability.

In their strategy decision, Ofgem sets out the outputs it expects to see. The exact form of these outputs vary to specific output targets that a network must match, rules that it must comply with or more general goals that a network must aim for.

For a number of outputs, there are specific financial incentives. These can take the form of rewards and/ or penalties for hitting/missing targets, ‘use it or lose’ funding for specific projects, a pot of funding that companies’ bid for and are awarded by a separate panel and discretionary awards where funding is awarded for more discrete ‘good customer service’.

⁶ http://www.ofwat.gov.uk/wp-content/uploads/2015/11/pap_pos201307finalapproach.pdf p14

⁷ http://www.ofwat.gov.uk/wp-content/uploads/2016/02/pap_tec140404pr14internalmeth.pdf

⁸ Strategy decision for the RIIO-ED1 electricity distribution price control – Overview (p23) Ofgem March 2013

⁹ Strategy decision for the RIIO-ED1 electricity distribution price control – Overview (p24-30) Ofgem March

Secondary deliverables are 'leading indicators' that enable Ofgem to monitor a network company's performance. Secondary deliverables can be part of or cut across a number of key performance indicators.

In their business plan submissions, network companies are expected to set out in some detail the outputs that they intend to deliver over the eight years of a price control period and the costs of delivering these outputs.

2.2.1.1 Ofgem assessment of outcomes

One of the five Ofgem criteria relates to outputs:

'Criterion 2 - Outputs: Does the plan deliver the required outputs?'

- This criterion assesses the outputs that the company intends to deliver in the eight years of the price control. Ofgem included a number of sub-questions or sub-criteria under this criterion – however as with the other criterion, these are simply guidelines to provide network companies' with a bit more detail.
- Has the business plan covered the outputs specified in our strategy decision or provided clear and compelling justification for any departures from the strategy decision?
- Has the Distribution Network Operator (DNO) explained the resource implications for delivery of each output identified?
- Has the DNO explained how it will deliver outputs, and justified the output baseline/forecast?
- Has the DNO explained the quality of its existing outputs and secondary deliverable information (including information on asset health, criticality and asset risk) and how it plans to improve this information in future?

What is green?

As with all criteria, whether a network company is rated red, amber or green is based on an overall assessment of outputs, with the sub-criteria detailed above only used as guidance, i.e. if a company is very strong or weak on one of the sub-criteria questions, this is taken into account in the assessment but would not in itself determine the overall colour.

For this criterion, Ofgem outline their assessment against each of the six output categories.

- Where a network company is rated **green** against this criterion, all six criteria will be typically described as acceptable or broadly acceptable (i.e. some minor points raised but not considered a serious issue).
- Where it is rated **amber**, an issue will have been flagged against one or more of the output categories which has led to Ofgem stating something like 'further development is needed'.
- For a **red** rating, a serious and fundamental issue will have been flagged with one or more of the output categories which has led Ofgem to consider that something has not been acceptably addressed.

Note that there is no number rating or consistent term used (i.e. acceptable/unacceptable); ultimately, the traffic light assessment is a judgement made by Ofgem officials after a comprehensive and thorough review of the business plans and any supporting evidence they can provide.

2.2.2 Ofwat – outcomes

During the PR14 price control, Ofwat wanted water companies to place considerable focus on customer outcomes, aiming to deliver an "outcomes-focused approach"¹⁰ to business plan formulation.

The specified Outcomes category was an integral part of the PR14 review, and made up one of the four assessment criteria used during the business plan review and determination. Companies were expected to deliver high levels of service that customers and society value, but in most cases, they were not prescribed the specific measurement criteria or even the process for how this would be achieved.

This customer focused policy would combine stakeholder engagement led performance commitments, with an incentive delivery mechanism to ensure that goals for PR14 accurately reflected the desires of customers.

¹⁰ http://www.ofwat.gov.uk/wp-content/uploads/2015/11/pap_pos201307finalapproach.pdf

2.2.2.1 Outcomes based approach

During stakeholder engagement activities, companies took part in a range of customer outcomes assessments, gauging the key outcomes which customers deemed important as part of service delivery. Although outcomes were specific to each individual water company, they were generally focused around key areas.

Companies would then propose a range of self-determined Performance Commitments (PCs), aiming to fulfil their proposed outcomes. In order to incentivise fulfilment, companies would tie an Output Delivery Incentive (ODI) to these performance measures. This incentive design would encourage the achievement of PCs through financial and reputational rewards and penalties. Some PCs and ODIs around sensitive areas were prescribed by Ofwat.

2.2.2.2 Ofwat outcomes assessment

The outcomes based approach faced substantial testing from Ofwat during assessment.¹¹ These tests examined the levels of customer engagement to determine outcomes as well as the suitability of the connected Performance Commitment and ODIs.

Within these three tests, there are a variety of sub-criteria, which when assessed at a granular level, combine to form an overall assessment for outcomes. These assessments are systematic in their approach, with specified guidelines which must be met for outcomes assessments to score the highest A rating. As an example, sub-criterion 2.7 assesses the outcomes commitments themselves.

- Criterion 2.7 – “How well has the company demonstrated that its proposed outcome commitments are consistent with the interests of consumers in the longer-term (in particular that its activities and outcomes will be economic and efficient in the longer term)?”

2.3 Management

In the context of the UK energy network and water regimes, management accountability is divided into two concepts:

- **Business plan accountability** – Accountability for the proposed cost, outputs and strategy set out in the business plans.

Management accountability is a nebulous concept.

Previous studies have highlighted that the ever increasing granularity of guidance could serve to reduce ownership and accountability of businesses for their business plans. When a regulator is heavily prescriptive in multiple areas of a proposal, there is a strong argument that the regulator itself is more responsible for the outcomes.

This was a key reason why both Ofgem and Ofwat have moved away from businesses merely submitting what the regulator has told them to do. They have instead required businesses to submit full and comprehensive business plans which the board and senior management take responsibility for delivering.

- **Data accountability** – Accountability for minimising errors in data and for mitigating errors when they occur.

Both Ofgem and Ofwat produce guidelines on how companies should ensure that the information and data that they provide to the regulator, and that they publish, is as accurate as reasonably possible. These guidelines vary in method, but are broadly similar in aim, with the idea being to promote transparency and hold the company’s management and board responsible for the data they submit.

2.3.1 Ofgem – business plan accountability

Management accountability is not set out as a specific part of the RIIO price control model and neither is it a separate criterion against which a network company is assessed. Rather, it is an implicitly expected part of the price control process, particularly when it comes to submitting business plans.

The RIIO model places great emphasis on network companies producing a ‘well-justified’ business plan that they adhere to throughout the eight year price control period. A key part of a well-justified plan is network companies taking responsibility for providing relevant information and evidence to justify their proposals as set out in the business plan¹².

Senior management are expected to take direct responsibility for the business plans; indeed, most plans will have an introduction and sign-off from the CEO¹³. A senior management team, including the CEO will usually be invited to present their business plan to Ofgem senior management

¹¹ http://www.ofwat.gov.uk/wp-content/uploads/2015/10/pap_con201304busplanning.pdf p20

¹² [RIIO Handbook](#), (7.7 p49) Ofgem

¹³ For example [ENW business plan](#) (p1)

and the Ofgem Board, GEMA. However, there are no formal sign off requirements or check-list that the board of each company has to go through, it is implicitly expected that they will take responsibility for the business plan submission. For many of the network companies, it is the most important document that the company will produce.

Within the RIIO business plans, when submitting costs and output proposals, network companies are expected to provide a wealth of supporting information. Networks are also expected to retain any further data and provide it to Ofgem if required.

2.3.2 Ofwat – business plan accountability

For the PR14 price control, Ofwat did not directly stipulate expectations for water companies on how best to ensure accountability of their respective business plans.

This was in contrast to previous Ofwat price controls. This switch away from the prescriptive approach gave companies more freedom to decide on their own stakeholder engagement, outcomes and levels of assurance¹⁴.

To ensure board and management accountability, water companies decide on their own assurance process (self and external) of business plans, while management and the board would be held accountable for the review, testing and challenge to ensure that they are focussed on delivering the outcomes.

Unlike Ofgem, Ofwat set out certain activities that each water company is required to carry out. They were required to:

- Produce a board statement explaining why its business plan is high quality, including the processes of internal and external assurance.
- Explain and outline their internal Governance Policy, and how it meets UK requirements.
- Have all board members formally sign off the business plan.

2.3.2.1 Ofwat post business plan submission assessment

There were no direct accountability criteria during the draft review of business plans in PR14, however Ofwat did test to account for accountability and data accuracy throughout assessments. These tests would check that the Board itself had provided assurance of the business plan:

- Test 2 Sub-criterion 8 – “How clearly has the company demonstrated that the proposed commitments can be measured and recorded consistently and that they will have the appropriate governance and quality assurance processes in place to ensure that the proposed performance commitments will be based on robust data?”¹⁵
- Test 15 – “Board assurance of a high-quality business plan.”
- Test 15.1B – “There is comprehensive and exceptional evidence that the data and evidence supporting the plan is of high quality.”

Guidelines for these areas were aimed at assessing whether company proposals contain appropriate accountability, governance and quality assurance processes. During the determination phase, companies which Ofwat did not deem to have supplied sufficient levels of self-assurance were given additional chances to provide information to either justify their assurance strategy, or supply additional evidence.¹⁶

The final decision was that companies would be subject to additional levels of assurance requirements where they had not justified their ability to deliver.¹⁷

2.3.3 Ofgem – data assurance

After the first price controls were set out, Ofgem introduced Data Assurance Guidance (DAG)¹⁸. The DAG requires companies to firstly self-assess the risk that any data they may submit is subject to errors and then how they can mitigate and manage these risks. The aim is to make companies more accountable for the information they provide and to ultimately increase confidence in the quality of the data.

¹⁴ Ofwat, July 2013, [Setting price controls for 2015-20 – final methodology and expectations for companies’ business plans](#) p 60

¹⁵ http://webarchive.nationalarchives.gov.uk/20150624091829/http://ofwat.gov.uk/pricereview/pr14/pap_tec140404pr14internalmeth.pdf p46

¹⁶ http://www.ofwat.gov.uk/wp-content/uploads/2016/02/let_stk20140730pr14assurance.pdf

¹⁷ http://www.ofwat.gov.uk/wp-content/uploads/2015/11/pap_pos201506comon1.pdf

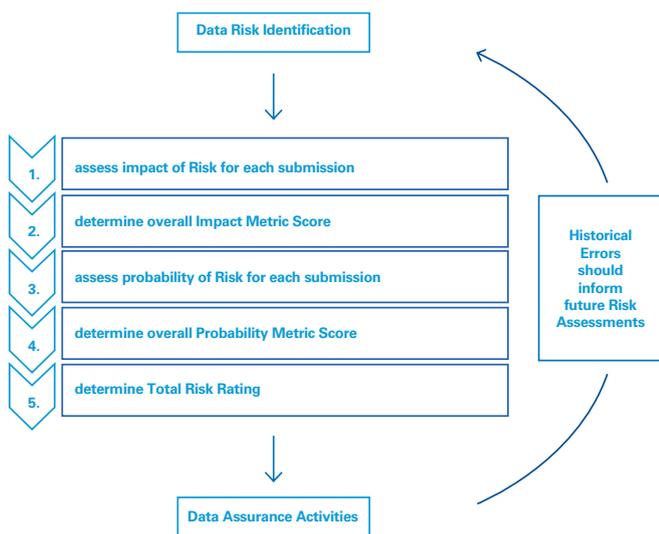
¹⁸ [Data Assurance Guidance for Electricity and Gas Network Companies](#) v1.3, (p6) Ofgem, Jan 2016

2.3.3.1 Data assurance guidelines

Assessment of data risk is the responsibility of the network companies; they must self-assess and report risk. Each network company is expected to follow the approach to that which Ofgem sets out in the DAG.

Networks are expected to follow a risk assessment process every time they submit regulatory submissions to the regulator. Ofgem’s guidance sets out a five stage process:

Figure 1: Ofgem five stage risk assessment process



This process is applied to actual data and forecast data. It can also include qualitative as well as quantitative data¹⁹.

The “data assurance activities” is a table of actions that a network company should perform for any regulatory submission. Each activity is defined in terms of:

- **who** undertakes the activity;
- **when** (i.e. under what circumstances) – for most activities this will be informed by the risk assessment; if risk is low then the activity may not be needed; and
- **what** the activity entails.

For example the data assurance activities include levels of sign-off and accountability. ‘Senior Manager’ (it is for the network company to define what this is) sign-off is required for all activities and the risk assessment will then determine how far up the management chain a data submission needs to be signed off, all the way up to board level for critical risks²⁰.

¹⁹ [Data Assurance Guidance for Electricity and Gas Network Companies](#) v1.3, (p6) Ofgem, Jan 2016 (P17)

²⁰ See p20 in Ofgem’s [Data Assurance Guidance for Electricity and Gas Network Companies](#) for an example of a table.

²¹ Ofwat Company Monitoring Framework http://www.ofwat.gov.uk/wp-content/uploads/2015/11/pap_pos201506comon1.pdf

2.3.3.2 The DAG reporting requirements

Network companies are required to produce an annual data assurance report. Each report is divided into past submissions and future submissions. Within the “Future Submission” section, network companies are required to report to Ofgem if and how the overall risk rating has changed since the previous year’s submission. In addition, they are required to report to Ofgem any areas where the overall risk rating remains high or critical but where there has been movement in the risk scoring to determine this.

As well as the annual submissions, the network company may need to make an additional data submission for a specific reason (which Ofgem call “irregular submissions”). In this case, the network company must also follow the same risk assessment and data assurance activities.

As well as the activities suggested by Ofgem, network companies undertake additional assurance activities. Essentially, it is the responsibility of the network company to provide as much assurance to Ofgem as possible.

2.3.4 Ofwat – data assurance

Ofwat published their Company Monitoring Frameworks which is ‘a tool to challenge all companies to provide information for customers and stakeholders that is reliable, timely and appropriate to the audience’²¹. The framework proposes monitoring categories which determine the level of scrutiny that a water company will be subject to and what they are required to provide the regulator with and/or publish themselves.

Companies are divided into three different assurance categories, these are:

Self

- Explicit sign off on the assurance that has been provided;
- Full transparency on the audit procedures; and
- A summary of the outcome of the assurance that has been carried out.

Targeted

- Carry out an exercise with stakeholders to target issues to address; and
- Publish a statement on this in the autumn of each year prior to submission of information.

Prescribed

- Publish their assurance plans before they report it, so that stakeholders can if necessary, provide comments or guidance to which the company would need to respond.

2.4 Engagement

Ofwat and Ofgem take a similar approach to engagement expectations, granting freedom to companies to engage with their customers and local stakeholders the way they deem most appropriate.

Both Ofgem and Ofwat expect engagement activities to exceed that of the end users of company services. The UK regulators require engagement to reach multiple stakeholders, which is a wide definition of groups and interests (not all of whom will agree with each other).

These include customers, consumer groups (which champion consumer rights and causes across a number of service sectors), Government bodies, national, regional and local groups and a myriad of specific interest groups such as environmental groups.

When it comes to the assessment process, these regulators use a markedly different approach, particularly around their evidence base.

2.4.1 Ofgem – engagement

Encouraging network companies to put their stakeholders at the heart of their decision making process is a key principle of the RIIO model of energy regulation²².

Ofgem itself conduct extensive stakeholder engagement as part of their strategy decision, which sets out what network companies' business plans should cover. It is then expected that the network companies' business plans are informed by extensive stakeholder engagement. Therefore, there are multiple opportunities for stakeholders to engage in the process.

The assessment of how effective this engagement has been and how effectively companies have presented their business plans forms the first of the five assessment criteria.

- Process – Has the network company followed a robust process?'

For Ofgem, the key to a successful business plan is that it is 'well-justified'. An important part of being well-justified is the process it underwent to create the plan. In their strategy decision, Ofgem set out, at a high level, what process they expect that network companies to follow²³.

Under this broad criterion, Ofgem set out key questions (effectively sub-criteria)²⁴.

- Is the business plan clearly presented, with all key content included?
- Has the DNO engaged with stakeholders, and explained how this has influenced its business plan?
- Has the DNO submitted, and justified, all data tables and the PCFM?
- Does the business plan provide a strategy for long-term delivery?

However when making their assessment, these sub-criteria are only a guide, an assessment of process is made on an overall basis.

What is green?

To be considered 'green' under these sub-criteria, a network's business plan must be considered by Ofgem to be clear and easy to follow, with plain and simple English.

It needs to demonstrate high quality and effective stakeholder engagement which should include:

- **Breadth of engagement** – this relates to who the network engaged with, and should include its customers, consumer groups and local/regional government.
- **Depth of engagement** – this is how the company has engaged with its stakeholders. Networks need to be proactive, such as issuing customer surveys, running customer focus groups and convening expert panels. Ofgem does not set out exactly what these activities should be, it simply looks for companies to demonstrate that they have found the best way to engage with their customers and wider stakeholders.
- **Timely engagement** – stakeholder engagement needs to be undertaken in enough time to allow stakeholders to feed into their business plans. High quality stakeholder engagement will have influenced the development of the plan from the outset, rather than as a way of endorsing already fully formed plans at the end of the process.

²² RIIO: [A new way to regulate energy networks](#), Ofgem, October 2010

²³ [Strategy decision for the RIIO-ED1 electricity distribution price control Business plans and proportionate treatment](#) (p16), Ofgem, March 2013

²⁴ [Assessment of the RIIO-ED1 business plans](#), (p9) Ofgem, November 2013

- **Evaluation and monitoring** – a network company needs to ensure it is evaluating and monitoring the effectiveness of its engagement rather than just completing activities that look good, but do not actually have any impact on the business plan.

Ofgem also expect network companies to set out in their business plans their long-term strategy for the development of the network and delivering value for money. Network companies were expected to link this strategy with the UK government carbon emissions and renewable energy targets.

2.4.2 Ofwat – engagement assessment

Ofwat highlighted stakeholder input as one of the key criteria of the PR14 price control, noting that stakeholder engagement and customer “acceptability” would play a significant role during assessment. Ofwat put forward only high level requirements for engagement, outlining that each company was to partake in:

- Local engagement between each company and its customers; and
- Customer Challenge Group processes.

Ofwat would also commission an additional customer advisory panel, to engage on cross firm industry issues, independently of business plan submission.

2.4.2.1 Local engagement and Consumer Challenge Group

Ofwat believed that companies would know best how to engage with local customers, and this led to a variety of different strategies being put forward. The mandatory Customer Challenge Group was an independent steering group to participate in engagement activities and to provide feedback to Ofwat on the engagement process.²⁵ Each water company was recommended representatives for appointment to their Customer Challenge Groups, which were expected to contain local community bodies, customers and national stakeholders.

2.4.2.2 Ofwat engagement assessment criteria

Table 10: Test 1 – Customer engagement and willingness to pay (WTP) evidence

Sub-criteria	Evidence base	Demonstrating...
1 “To what extent has the company demonstrated an effective customer engagement process?”	Consumer Challenge Group Feedback and Business Plan	<ul style="list-style-type: none"> • Range of engagement techniques • Range of customers consulted • Explanation of use of engagement findings • Methodologies that adhere to best practice guidance
2 “To what extent has the company demonstrated effective engagement with wider consumer interest, including environmental interests, generally and through their customer challenge group?”	Consumer Challenge Group Feedback and Business Plan	<ul style="list-style-type: none"> • Consultation levels with other regulators with a long term outlook • Engaged stakeholders on possible future issues • Ongoing dialogue on areas where stakeholders disagree • Addressed stakeholder views

²⁵ Ofwat, [Customer challenge groups](#)

Sub-criteria	Evidence base	Demonstrating...
3 “How far has the company demonstrated a robust approach to gathering willingness to pay information and in mapping this to its outcomes, performance commitments, and outcome delivery incentives?”	Consumer Challenge Group Feedback, independent expert reviews and Business Plan.	<ul style="list-style-type: none"> • Robust quantitative approach to measure willingness to pay. • Robust and cross checked findings of willingness to pay to outcomes. • Account for other factors impacting on invoices during WTP estimates. • Appropriate use of WTP estimates within business plan.

2.4.2.3 Ofwat assessment of outcomes

Assessment of a company’s stakeholder engagement activities came through a joint scoring test of each company’s customer engagement process, as submitted through a multitude of sources. These tests were granular in their assessment, and were ranked on the Ofwat (A-D) scale. Ofwat would look to ensure companies had either met or exceeded stakeholder expectations, or alternatively where this was not possible, have provided supporting evidence.

Example expectations for the (A-D) scale:

- A - Exceeding stakeholder expectations alongside exceptional evidence.
- B - Robustly addressed stakeholder expectations with convincing evidence.
- C - Insufficient or unconvincing evidence of protecting customer interest.
- D - Substantial evidence required to convey protection of customer interest.

Assessment criteria looked at the range, time, influence and reliability of engagement activities, and in addition assessed willingness to pay evidence for water company proposals. Ofwat also required proof that additional stakeholders’ views had been taken into account, such as community bodies.

Consumer Challenge Groups played a crucial role during the assessment process. Alongside business plans, these bodies would submit an independent engagement assessment to Ofwat, which would be used during scoring.

2.5 Risk

Ofgem and Ofwat both require businesses to complete a risk assessment as part of their submission. Neither regulator sets out how businesses should manage their business risk, but one of the aims of the RIIO price control regime is to make energy networks behave like a competitive business. RIIO requires risk to be borne by the party best able to manage that risk efficiently. This can be businesses, customers or both. Ofwat requires businesses to demonstrate how they have balanced risk allocation and mitigation between parties, including customers, investors and the business. Ofwat also use a quantitative scenario modelling approach to test each water business’s submission against a range of possible future outcomes.

Both regulators provide guidance on how to manage uncertainties, and will introduce uncertainty mechanisms, which allow changes to revenue if a trigger event occurs. There tends to be a high threshold for scale and the level of control available to businesses in order to introduce an uncertainty mechanism.

In the UK, the network businesses tend to be reasonably risk averse. In practice, businesses differ little in their approach to identifying and assessing risk. While the businesses will seek a regulatory steer on risk management, the approach tends to focus on identifying the party best able to control the risk and placing responsibility with them.

As well as managing business risk in their business plan, companies are required to manage the risk of submitting poor quality (i.e. error ridden) data.

2.5.1 Ofgem – risk assessment

One of the key aims of RIIO is to make energy network companies behave like a normal competitive business (rather than a regulated business reliant on the direction of the regulator). As such the RIIO model requires companies to have responsibility for managing ‘normal’ business risk.²⁶

Ofgem does not set out how companies should manage their business risk, this is for network companies to manage. Ofgem do outline how ‘uncertainties’ should be managed, defined as factors that will impact a network company’s outputs and expenditure requirements. Under RIIO, risks should be borne by the party best able to manage them efficiently; in some cases, this will be the network company, in other cases it will be customers. The RIIO framework includes a number of ‘uncertainty mechanisms’ which allow changes to the revenue that a network company can collect during the price control.

Uncertainty mechanisms allow for an uncertainty to be transferred or shared with a network’s customers. This may actually be to the benefit of customers by lowering the cost of capital. However, Ofgem state that uncertainty mechanisms should be limited to where it genuinely can be demonstrated to deliver value for money for current and future customers. They should not be used protect network companies against all forms of uncertainty²⁷.

Ofgem expect network companies to address business risk and how a business proposes to address uncertainties in its business plan. When assessing business plans, managing uncertainty and risk is the fifth of Ofgem’s five assessment criteria (but this does not indicate a lesser weighting)²⁸, being:

- ‘Uncertainty & Risk: How well does the plan deal with uncertainty and risk?’

Under this criterion there are two sub criteria:

- Has the network company clearly articulated the key uncertainties it faces and considered and how it will address them (e.g. including uncertainty mechanisms)?
- Has the DNO considered risk and how to mitigate those risks?

What is green?

To be judged ‘green’, a company needs to set out a risk strategy demonstrating that it is well thought through and show how risks are mitigated.

Network companies can propose additional uncertainty mechanisms and still be marked green if their mechanism is well-justified. To be well-justified, a network company must demonstrate that including the mechanism will benefit customers, any potential downsides can be mitigated and that the proposed mechanism is coherent with any other uncertainty mechanisms.

If Ofgem judges that a proposed mechanism is not justified and that a company is trying to unduly shift risk onto the customer via an uncertainty mechanism, this is likely to result in an amber or red score.

2.5.2 Ofwat – risk assessment

In PR14, companies were handed a large degree of autonomy for how they managed the partition of risk within their business plans, particularly through the introduction of menu regulation and from the freedom granted to companies to propose custom incentive mechanisms, wholesale WACC(s), retail net margins and uncertainty mechanisms.

Companies would need to convince Ofwat of the fulfilment of their two statutory duties on risk²⁹. The first to protect the interests of customers and the second to ensure that an efficient company can finance their functions.

The management of Risk and Reward was one of the four key assessment criteria used by Ofwat for its PR14 price control, with a focus on how companies would balance risk allocation, rewards and penalties between all parties, being:

- “Key Criteria 4 – Risk and reward – how the company’s proposals balance risk and the rewards for bearing those risks between consumers, including current and future customers and the environment, and the company and its investors.”

²⁶ RIIO: A new way to regulate energy networks, Ofgem, October 2010.

²⁷ Strategy decision for the RIIO-ED1 electricity distribution price control: Overview (Section 8 – ‘Managing uncertainty’)

²⁸ Strategy decision for the RIIO-ED1 electricity distribution price control Business plans and proportionate treatment (p22), Ofgem, March 2013

²⁹ https://www.ofwat.gov.uk/wp-content/uploads/2015/11/gud_tec20140127riskreward.pdf p2

The initial proposed assessment framework was for each company's risk mitigation proposals to be assessed based on two tests:

1. Test 8 – Risk analysis

- “Criterion 8.1 - How far has the company provided sufficient information – including on company specific risks – for us to analyse the impact of risks on consumers and companies?”
- “Criterion 8.2 - To what degree are the companies' proposed risk impacts plausible and acceptable?”

2. Test 9 – Level and allocation of risk

- “Criterion 9.2 - “In deriving these proposed allocations, has the company made appropriate assumptions in relation to the efficient mitigation of risk?”

Ofwat scenario modelling

Ofwat measure risk consistently across all water companies, and use a Quantitative Scenario Modelling approach to test water company submissions against a range of possible future outcomes.³⁰

Companies were required to submit information based on up to nine different pre-defined scenarios³¹, Ofwat would in turn analyse company submissions based on an upside and downside possibility for each of these scenarios.

The following are two example industry scenarios:

- “Scenario 1 - Household growth (optional). In this scenario, the number of households is assumed to be either higher or lower than assumed in the base case in the business plan.”
- “Scenario 2- Industrial demand (optional). This scenario varies the level of industrial demand.”

Scenarios were both consistent across industry (Scenario 1-5) and water company specific (6-9), to allow Ofwat both a comparative and granular set of findings for each water company's risk assessment. Non-economic risks such as Rainfall were also assessed (Scenario 5). Assumptions on guidelines were published for the Scenario Modelling³², but they were not prescriptive.

Ofwat's assessment of risk

During the initial assessment of company business plans, Ofwat had concerns surrounding the quality of the Risk and Rewards portions of multiple company proposals, and engaged as a redesign of the assessment framework for risk for PR14. Ofwat's concerns were that companies' proposals were “*not in alignment with market evidence*”³³.

Companies which had passed alternative assessment areas, were given the opportunity to accept a broad range of requirements to mitigate shortfalls³⁴. If companies accepted these broader proposals, they were awarded the advanced status for the Risk assessments.

Uncertainty mechanisms

In addition to the uncertainty mechanisms used within PR09, a broad range of additional uncertainty mechanisms were proposed within company business plans. Ofwat's final decision was that in any area of operations where the company has the ability to influence the impact on their business, at least part of the risk should remain with the company. Similarly, only within areas where the company has no influence on outcomes should risk be wholly borne by customers.³⁵

³⁰ http://www.ofwat.gov.uk/wp-content/uploads/2016/01/rpt_com201307pwcassump.pdf

³¹ http://www.ofwat.gov.uk/wp-content/uploads/2015/12/pap_pos201307finalapproachapp5.pdf A20 P53

³² http://www.ofwat.gov.uk/wp-content/uploads/2016/01/rpt_com201307pwcassump.pdf

³³ <http://www.ofwat.gov.uk/ib-2813-change-to-ofwats-price-review-process/>

³⁴ https://www.ofwat.gov.uk/wp-content/uploads/2015/11/gud_tec20140127riskreward.pdf

³⁵ http://www.ofwat.gov.uk/wp-content/uploads/2015/10/det_pr20141212riskreward.pdf p16

Appendix 3

Adjustments and monitoring performance in UK energy and water.

3.1 How Ofwat and Ofgem set returns

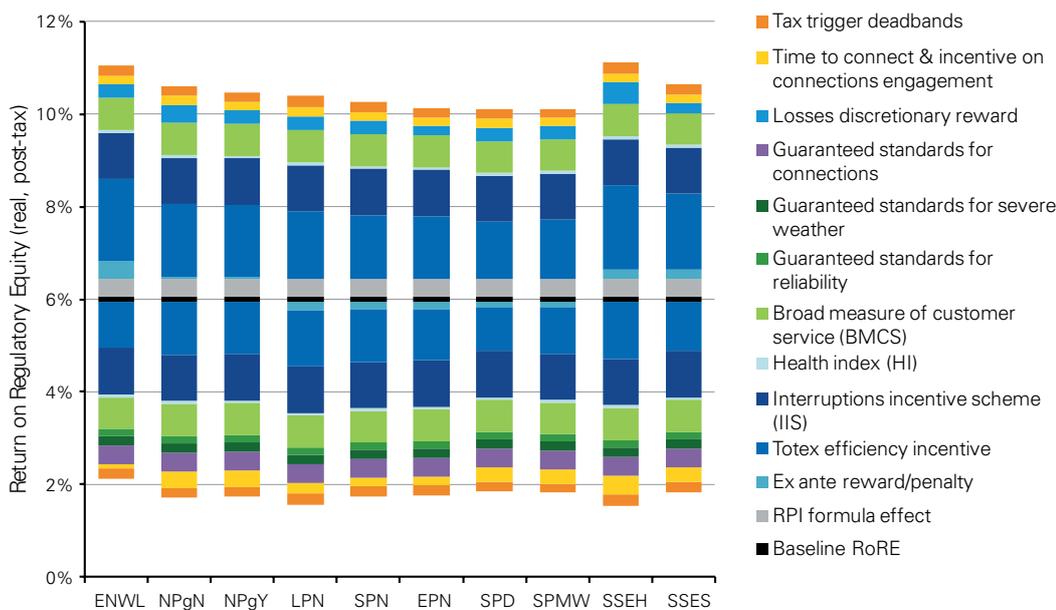
UK energy network and water companies have an allowed revenue set after negotiations with the regulator at the price review stage. In the UK, the regulators refer to the 'Return on Regulatory Equity' (RoRE). At the start of a price control, the RoRE is a range. The set cost of equity is that the baseline RoRE actual returns will be higher or lower than this baseline, within the RoRE range.

For example, Figure 2 below shows the range of returns the 'slow tracked' electricity distribution companies could expect to make. In this case, 6.0% is the 'baseline RoRE' as this is the cost of equity that Ofgem set for each of

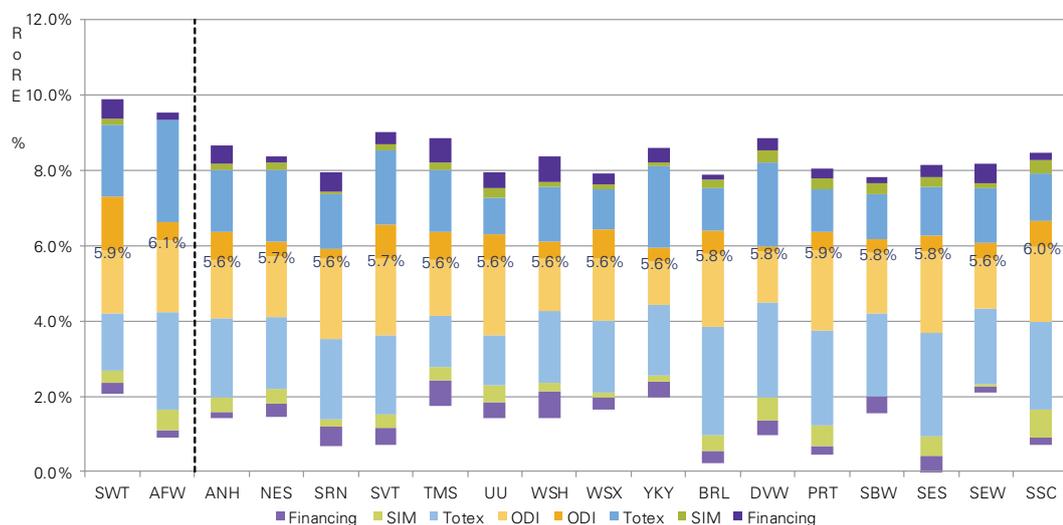
the slow tracked businesses. Network businesses could then perform better or worse than this baseline return on equity depending on their performance the incentives set. Note that generally there is slightly more of an upside than downside to RoRE returns. Note also that even the worst performing company will make a return, it could just be very low (circa 2%).

Ofwat use a similar method and Figure 2 shows the RoRE range for the water companies in PR14.

Figure 2: Ofgem diagram on the ranges for RoRE for the 'slow tracked' electricity distribution companies³⁶



³⁶ From [RIIO-ED1 Slow track decision](#) (p46). Note that WPD (as the only fast tracked company) is not included in the Figure.

Figure 3: Ofwat: RoRE range for water companies³⁷

3.2 Deriving charges from allowed revenue

In both energy and water in the UK, charges are derived from allowed revenue using a charging methodology³⁸ (energy) or charging scheme³⁹ (water). The businesses themselves are responsible for their own charging, following guidance set out by the regulator (and subject to review by the regulator).

In any given year, charges to customers⁴⁰ should match with the allowed revenue in that year. In reality however, it is difficult for revenue collected from customers to exactly match with the allowed revenue as, no matter how good forecasting is, it is not possible to know exactly how much a company can expect to collect each year. Often there will be under or over collection of revenue. The regulator will then make appropriate adjustments in the following year. In effect, UK energy and water charges are constantly being adjusted up or down year on year, which is exacerbated further by adjustments to allowed revenue.

3.3 Within period adjustment for performance

Both RIIO and PR14 use incentives to encourage businesses to deliver overall efficiency and outcomes. These incentives adjust the allowed revenue (up or down) based on each business's performance. How and when allowed revenue is adjusted for performance varies between Ofgem and Ofwat.

3.3.1 Ofgem – annual iteration process

In the RIIO price control, there is an annual adjustment of revenues, including those due to incentive performance. Revenue is also adjusted for over/under recovery in previous price control periods. This process is called the Annual Adjustment Process (AIP).

The AIP is a complex process, with most adjustments to revenue having a two year lag before taking effect. The diagram below depicts how revenue is adjusted where T = the year allowed revenue is adjusted.

³⁷ Final price control determination notice: policy chapter A7 – risk and reward

³⁸ Ofgem, Charging arrangements

³⁹ Ofwat, Charging scheme rules

⁴⁰ Indirectly in energy – through charges to energy retailers who then pass this cost on in the bill their customers.

T-2: Collect data for a given year.



T-1: Submit the data for this the following financial year. Any changes to revenue as a result of this data (i.e. incentive revenue/penalties) feeds into that year's AIP (which closes by November of that year).



T: The AIP then adjusts revenue for the following financial year (two years after the performance was actually recorded).

Example

If a company received a reward for performance under the customer service incentive for the year 2014/15:

- Financial year 2014/15 (**t-2**) is the year in which the reward is earned.
- In July 2015 (**t-1**), the results of the customer service outputs are submitted alongside all other results in the annual data report to Ofgem. In November 2015, the subsequent (upward) adjustment to revenue is made in the AIP.
- This then adjusts the allowed revenue for the financial year 2015/16 (**t**).

3.3.2 Ofwat – Log-up process

Within PR14, the majority of all incentive adjustments to allowed revenue take place on an aggregate basis at the end of the five year price control period. The ODI mechanism is used to calculate adjustments to revenue over the course of PR14, depending on annual company performance over the regulatory period (the current period is 2015-19).⁴¹ Each ODI will apply an annual reward or penalty based on the company's performance levels from the respective year. Incentive adjustments based on all of a company's ODIs are then aggregated over the price control period and applied during PR19.

Previously, Ofwat has solely used aggregate incentive adjustments, but PR14 introduced adjustments to revenue based on performance levels which could be applied during a price control period. Three water businesses (Anglian Water, Severn Trent Water and South West) have negotiated with Ofwat to allow for in-period ODIs, revenue adjustments which take place within the price control period. Where appropriate, these companies can apply to have adjustments (rewards or penalties) made available to revenue adjustments for the 2017-18 year, as opposed to during PR19. The in-period ODI calculation process is continuing to develop, and has been defined only at a high level as Ofwat plan to evolve this process over PR14 based on their initial findings.

3.4 Adjustments for uncertainty

Dealing with uncertainty within the regulatory period is a key consideration in the UK, particularly in energy where there is a longer (eight year) control period. However, RIIO still allows only a small number of tightly defined uncertainty mechanisms. Ofgem also recently decided not to take up the option for a mid-period review in gas distribution and has opened up only a very small subset of issues related to Transmission.

In both RIIO and PR14, pre-set 'uncertainty mechanisms' allow for adjustments to be made in areas where there was a degree of uncertainty while the price control was being set. These allow for changes to the revenue that businesses can collect within the regulatory period. Businesses are expected to deal with business risk as much as they can, and as any 'normal' unregulated business would. Uncertainty mechanisms tend to be used only where risks are demonstrably out of the control of the business, and would have a significant impact on their costs.

As RIIO is a longer eight price control, uncertainty mechanisms take on a greater degree of importance compared to shorter price control periods.

⁴¹ http://www.ofwat.gov.uk/wp-content/uploads/2016/07/prs_in1608calculationinperiododi.pdf

3.5 Monitoring performance

Continual monitoring of performance is an important consideration of a price control regime, particularly if there are financial adjustments for performance during the price control period. In the UK, both Ofgem and Ofwat include a significant degree of performance monitoring.

3.5.1 Ofgem

Ofgem require companies to report on a large amount of output data in a 'Regulatory Reporting Pack (RRP)'⁴². The RRP is a large number of data tables and other information that the energy businesses are required to submit by the end of each July for the previous regulatory year (i.e. data for 2015/16 is submitted in July 2016). The RRP is a significant annual exercise for the network businesses and for Ofgem.

Energy network businesses are also expected to produce an annual report for their customers and stakeholders which explains how they have performed in the previous year. This is a higher level report than the RRP. It sets out the business's performance and what this means in terms of income from incentives⁴³. This report is intended to be easily accessible to a range of stakeholders, avoiding technical detail and providing only high level data.

Ofgem will also publish an overall annual report summarising performance across each of the businesses in each sector. For example, Ofgem publish an annual report on gas distribution businesses.⁴⁴ This report includes the latest view of the RoRE for each business, based on revised actual performance data and revised forecast performance.

3.5.2 Ofwat

Ofwat require companies⁴⁵ to deliver a detailed annual performance report (APR) which is used to assess performance on an ongoing basis. In addition to the APR, companies are expected to deliver their reporting proposals set out in their PR14 submissions, which include their stakeholder reporting commitments.

The APR are published each July. The reports are accompanied by constituent data tables containing financials, price control data and updates on the business's PR14 performance commitments. Ofwat published detailed guidelines on reporting requirements to inform these reports and data submissions.

⁴² E.g. [Electricity Distribution Regulatory Instructions and Guidance \(RIGs\)](#)

⁴³ E.g. a Gas distribution company annual report

⁴⁴ Ofgem, [Gas Distribution \(RIIO-GD1\) annual report 2014/15](#)

⁴⁵ <http://www.ofwat.gov.uk/regulated-companies/company-obligations/annual-performance-report/>

Appendix 4

Data sources for Chapter 3 UK examples

Example 1 – UK electricity distribution business

Page 70 – <http://www.westernpower.co.uk/docs/About-us/Stakeholder-information/Our-future-business-plan/WPD-RII-ED1-Business-Plan/WPD-RIO-ED1-Business-Plan.aspx>

Page 80 – <http://www.westernpower.co.uk/docs/About-us/Stakeholder-information/Our-future-business-plan/WPD-RII-ED1-Business-Plan/WPD-RIO-ED1-Business-Plan.aspx>

Example 2 – UK electricity distribution business

<http://www.bbc.co.uk/news/uk-england-lancashire-35279138>

<http://www.enwl.co.uk/news-and-press/latest-news/2016/01/12/12-01-16-storm-desmond-our-position-on-compensation>

<https://www.davidmorris.org.uk/news/david-morris-mp-responds-electricity-north-west%E2%80%99s-compensation-decision>

Example 3 – UK electricity distribution business

Page 80 – <http://www.westernpower.co.uk/docs/About-us/Stakeholder-information/Our-future-business-plan/WPD-RII-ED1-Business-Plan/WPD-RIO-ED1-Business-Plan.aspx>

Page 80 – <http://www.westernpower.co.uk/docs/About-us/Stakeholder-information/Our-future-business-plan/WPD-RII-ED1-Business-Plan/WPD-RIO-ED1-Business-Plan.aspx>

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

Example 4 – UK water business

[http://www.thameswater.co.uk/five-year-plan-summary-2015-2020\(1\).pdf](http://www.thameswater.co.uk/five-year-plan-summary-2015-2020(1).pdf)

[https://www.thameswater.co.uk/tw/common/downloads/about%20us%20-%20corporate%20responsibility/AMP6 - Outcomes Reporting Policy.pdf](https://www.thameswater.co.uk/tw/common/downloads/about%20us%20-%20corporate%20responsibility/AMP6_-_Outcomes_Reporting_Policy.pdf)

Example 5 – UK water business

<https://stakeholder.affinitywater.co.uk/docs/AW-summary-business-plan-2015-2020.pdf>

http://www.ofwat.gov.uk/wp-content/uploads/2016/03/pap_pos140404pr14enhanced.pdf

Inherent Limitations

This report has been prepared as outlined in Chapter 2 of our report *A practical application of the PREMO framework*. 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 Chapter 2 of our report *A practical application of the PREMO framework* 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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