



Essential Services Commission

PREMO Assessment Tool

1. Introduction	2
2. Outcomes	4
3. Management	6
4. Engagement	9
5. Risk	11

1. Introduction

This document sets out a suggested Assessment Tool:

- **on which the Commission could base its guidance to businesses for self-rating their price submissions according to the Commission’s expectations; and**
- **the Commission could adopt for making its own ratings of businesses’ price submissions.**

The Assessment Tool provides a set of guiding questions and examples of what might constitute a “leading”, “ambitious”, “standard” or “basic” price submission.

The Assessment Tool does not seek to provide a check-list that represents all features of price submissions within these rating categories. This would run counter to the objectives of PREMO to incentivise businesses to put forward their best service and price offer to customers in their price submissions. Further, a detailed check-list would not sufficiently account for the diversity of water businesses and their customers. There will be a number of ways a business might demonstrate that it has a “leading” or “ambitious” price submission, for example.

The Victorian water businesses could use the Assessment Tool as follows:

- to provide an initial view of where the business’s current price submission activities, processes and strategies sit against the Commission’s expectations of a “standard” submission;
- identify what additional activities the business should consider, should it be seeking a grading higher than standard (i.e. “leading” or “ambitious”); and
- identify and avoid the types of activities that would lead the Commission to rating an activity, process or strategy as “basic”.

To assist an accurate self-rating, each business could use the Assessment Tool continuously during the development of its price submission, such as at the outset of, and after the completion of:

- the project planning;
- the overarching strategic objectives/plan;
- the financial and economic forecasting; and
- the draft submission.

Further, each business might seek to continuously engage with the Commission during the price review to test their strategies, methods and forecasts, including expectations regarding the direction of their submission and the subsequent overall rating.

Within the Assessment Tool, blank spaces indicate that the Commission expects that the examples provided under “standard” will carry forward. This would not preclude a business from being innovative and seeking better outcomes that are not detailed within each table. The Commission could encourage businesses to think outside the square on how they can provide a leading or ambitious price submission. In other words, the Commission would expect businesses to put forward their “best offers”, rather than reverse-engineering a price submission to meet the requirements of a preferred rating.

The Commission expects that all submissions will meet the basic requirements of a standard submission. Failure to do so would risk a basic rating, or entry into the “red zone”, which would allow the Commission the discretion to require a resubmission, or to set a shorter regulatory period for that business.

It is not intended that the guiding questions and examples in the Assessment Tool are individually rated (as “leading”, “ambitious”, “standard” or “basic”) under each REMO element. Rather, a single rating will be applied to each element of REMO based on overall achievement against 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 price 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”.

1.1 Scope

This paper set out an analysis of the Commission’s expectations of how businesses would achieve different ratings under the Outcomes, Management, Engagement and Risk elements of the Commission’s PREMO framework.

The sole purpose of this paper to assist the Commission to develop guidance for both for itself and Victoria’s water businesses, on how to rate a water business’s pricing submission under the PREMO framework.

2. Outcomes

In order to receive a standard rating, the Commission expects a water business:

- through engagement with its customers, to develop a set of outcomes;
- to submit a price submission that contains a set of activities to achieve these outcomes; and
- to propose outcomes that as a minimum, deliver the same level of service without an increase in the average cost of delivering those services.

Outcomes will be clearly defined and measured through a set of quantifiable outputs. Examples are contained in Section 3.3 of *A practical application of the PREMO framework*.

It will be incumbent on each business to monitor performance within the regulatory period against the agreed set of outcomes, and to report to its customers annually on its performance. Reporting should be in a form that is meaningful to customers, and widely accessible to all socioeconomic groups and demographics.

To achieve a leading or ambitious rating:

- a water business must be able to demonstrate improvements in customer value; and
- define all outcomes in terms of the customer experience. Targets must be more ambitious and innovative than current service performance.

Where a water business:

- is unable to clearly demonstrate within its price submission the delivery of outcomes consistent with feedback (provided through customer engagement); or
- is proposing a lessening of service outcomes and/or a lessening in the efficiency of outcome delivery (that was not explicitly sought by customers through engagement),

the business risks a basic rating.

Table 1 How to rate Outcomes

Guiding questions	1) Expectations of a standard submission	2) Additional requirements to 1) for an Ambitious rating	3) Additional requirements to 2) for a Leading rating	4) Risk of downgrade to Basic
<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? 	The outcomes proposed are broadly consistent with existing levels of service provided to customers.	The outcomes proposed reflect a significant improvement in customer value delivered.	The outcomes proposed reflect a step change improvement in customer value delivered. The business proposes outcomes that lead the industry.	The business has proposed degradation in customer outcomes, not justified or supported by customer feedback.
	The business has mostly defined outcomes in ways that reflect the customer service experience.	The business has defined all outcomes in ways that reflect the customer service experience.		Most outcomes are defined as outputs (that is, at a granular level consistent with practice in the 2013 water price review).
	The outcomes proposed generally reflect customer preferences and priorities revealed through engagement.			The outcomes proposed do not clearly 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.			Where applicable, the business has not explained or justified why outcomes proposed are not consistent with customer preferences and priorities.
	The level and composition of forecast expenditure is consistent with the outputs proposed. The expenditure profile has changed where required to reflect customer priorities.			The level and composition of forecast expenditure is inconsistent with the outputs proposed. The expenditure profile has not changed to reflect customer priorities.
	The business has proposed and justified appropriate measures and timelines (or a set of outputs and deliverables) to track performance against the outcomes.			The business has not proposed appropriate measures and timelines to track performance against outcomes.
	The business has committed to and described a process for monitoring and reporting to customers, within period performance against outcomes.			No defined process for monitoring and reporting to customers within period performance against outcomes.

3. Management

The Commission expects that in order for a submission to receive a standard rating:

- a water business's Board and senior executive team will attest to the completeness, accuracy, consistency, robustness and validity of all information and documentation submitted. The price submission should comply with the requirements of the Commission's Guidance Paper, Victorian Government policy statements and any relevant regulatory instruments/ legislative requirements.
- the submission's forecasts will be based on sound methodologies; and
- the submission will propose productivity improvements at least equivalent to the Commission's' operating expenditure hurdles, absorb "cost push ins" and mitigate potential price shocks to customers.

For a business's submission to be considered leading or ambitious, it should also propose material or industry leading improvements in productivity and capital efficiency.

A business will risk a basic rating where:

- it proposes costs that do not meet past expectations about cost efficiency improvements;
- its submission is not self-evidently compliant with the requirements of the Commission's Guidance Paper;
- it does not meet the Commission's timelines;
- it is unable to explain and/or justify its forecasts;
- there are errors throughout its submission,
- there are inconsistencies in the submission's forecasts or assumptions; or
- its submission does not otherwise, meet the Commission's expectations for a standard rating.

Table 2 How to rate Management accountability

Guiding questions	1) Expectations of a standard submission	2) Additional requirements to 1) for an Ambitious rating	3) Additional requirements to 2) for a Leading rating	4) Risk of downgrade to Basic
<ul style="list-style-type: none"> 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? 	<p>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).</p>	<p>The business has proposed a material improvement in the productivity of the services delivered. Forecast efficiency improvements significantly exceed the Commission's one per cent controllable operating expenditure efficiency hurdle (used in 2013 water price review).</p>	<p>The business has proposed a step change improvement in the productivity of the services delivered. Efficiency improvements exceed, by a very significant margin, the Commission's one per cent controllable operating expenditure efficiency hurdle (used in 2013 water price review). The productivity improvement places the business as a leader on cost efficiency in the industry.</p>	<p>The business has not proposed productivity improvements. The business does not meet the Commission's one per cent controllable operating expenditure efficiency hurdle (used in 2013 water price review).</p>
	<p>The business can provide business cases and justification for all major projects and capital programs, including evidence that a range of options have been considered.</p>	<p>The business has proposed a material improvement in the efficiency of its capital program.</p>	<p>The business has proposed a step change improvement in the efficiency of its capital program. The efficiency improvement places the business as a leader on cost efficiency in the industry.</p>	<p>The business has not provided timely access to robust business cases that validate the basis for all major projects and capital programs.</p>
	<p>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.</p>			<p>The senior executive team and/or the Board of Directors have not attested that it has undertaken appropriate internal procedures to assure themselves of the quality and accuracy of their price submission.</p>
	<p>The price submission addresses all requirements specified in the Commission's Guidance Paper.</p>			<p>The price submission does not address all requirements set out in the Commission's Guidance Paper</p>
	<p>The price submission contains no material or obvious errors or omissions.</p>			<p>The price submission and its supporting documents contain errors and/or omissions of sufficient concern to the Commission.</p>

Guiding questions	1) Expectations of a standard submission	2) Additional requirements to 1) for an Ambitious rating	3) Additional requirements to 2) for a Leading rating	4) Risk of downgrade to Basic
	The financial template provided to the Commission is completed with no missing information, and is consistent in every respect with the written price submission.			The financial template is incomplete and/or contains inconsistent information as compared to the price submission.
	The price submission and supporting information are provided to the Commission by the time requested.			Deliverables are submitted after the deadline.
	Forecasts for expenditure and demand are based on sound methodologies and assumptions.			The business has adopted a forecasting method that biases the outcome to being beneficial to the business over customers.
	The price submission is 'internally consistent'; demonstrating alignment between different elements of the price submission (e.g. there is consistency between the outcomes proposed, and demand and expenditure forecasts).			The price submission is contradictory across main elements of the submission.
	The business has not sought to absorb "cost push-ins".			
	The business has not proposed adequate mitigation strategies to avoid price shocks			
	The business retains supporting documentation to justify its proposals, with ongoing access available to the Commission.			The business has not readily provided timely access to meaningful and robust supporting documentation, on request from the Commission.

4. Engagement

The Commission expects that a submission that receives a standard rating will demonstrate how a business has;

- effectively captured customer views in on major issues of interest to customers; and
- considered and addressed these views

consistent with the minimum expectations of the Engagement Tool set out in Chapter 5 of the Commission's Position Paper² of May 2016 (Position Paper).

For a business's submission to be considered leading or ambitious, it would need to be able to demonstrate that the submission is based on engagement that extends, as far as possible: the form; timing; and content, as described by Section 5 of the Position Paper.

The risk of a basic rating would arise where a submission is based on a scope of engagement activities whose form, timing and content are limited to the minima described by Section 5 of the Position Paper and could for example, be consistent with a business:

- engaging with customers after it had developed its proposals;
- only seeking input from a small section of its customer base;
- engaging on an agenda of issues on which customers have not had meaningful input; and
- designing a process to elicit pre-determined outcomes.

2. Essential Services Commission, A new model for pricing services in Victoria's water sector, Position paper, May 2016.

Table 3 How to rate Engagement

Guiding questions	1) Expectations of a standard submission	2) Additional requirements to 1) for an Ambitious rating	3) Additional requirements to 2) for a Leading rating	4) Risk of downgrade to Basic
<ul style="list-style-type: none"> 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? 	<p>The business demonstrates that engagement has occurred on matters that customers reveal are the most important to them.</p> <p>A business demonstrates that engagement was undertaken early, prior to locking in key strategies and priorities.</p> <p>A business demonstrates that the business re-tested its position and proposals with customers as it developed its price submission.</p> <p>The form of customer engagement is justified as being fit for purpose given the content and circumstances facing the business and its customers.</p> <p>The business can demonstrate that the information provided to customers was appropriate given the purpose, form and content of customer engagement.</p>	<p>The business is able to demonstrate that the engagement significantly extends beyond the expectations of a standard submission and reflects meaningful progression towards a longer term objective of meeting the requirements of leading rating.</p>	<p>The business is able to demonstrate that the engagement reaches all of the outer boundaries of the Commission's engagement tool by:</p> <ul style="list-style-type: none"> empowering customer participation; being ongoing; and conducts meaningful consultation with customers on price and service trade-offs and/or the entire submission. 	<p>Engagement has not occurred on matters that are important to customers or significant to the outcomes they receive and prices they are charged.</p> <p>Engagement was undertaken late, after the business had developed its key strategies and priorities.</p> <p>The business has not retested its position and proposals with customers as it developed its price submission.</p> <p>The business has failed to demonstrate that its engagement program elicited information that it could use to shape the strategic direction and priorities in its price submission.</p> <p>Information provided to customers was written in technical jargon, and/or was not appropriate for customer use.</p>
	<p>The price submission describes what was learned from customer engagement, and how this influenced its proposed outcomes, expenditure (composition and level) and prices.</p>	<p>The outcomes proposed reflect a significant improvement in customer value delivered, consistent with customer priorities.</p>	<p>The outcomes proposed reflect a step change improvement in customer value delivered, consistent with customer priorities.</p> <p>The business proposes outcomes that lead the industry.</p>	<p>The price submission does not clearly link the outcomes of engagement to the outcomes proposed, and the alignment of outcomes to expenditure and prices.</p>

5. Risk

In order for a submission to achieve a standard rating, the Commission expects that a business will:

- have demonstrated that it has followed the requirements of the Statement of Obligations and requirements included in the Commission’s Guidance Paper (to be published in November 2016);
- be able to provide analysis and support for its evaluations of risk and their costs; and
- have only allocated revenue and cost risks to customers that they can bear appropriately and without experiencing material price instability.

It should be noted that while taking less risk averse approaches to expenditure is desirable for customer prices, businesses must take balanced approaches. We understand that the Commission will seek to avoid businesses taking on risks that they cannot responsibly manage on behalf of customers, in order to achieve a higher level of reward.

For a business’s submission to be considered leading or ambitious, a business would need to demonstrate both an appropriate appetite for risk and a credible capability to manage the additional risk it proposes to bear. The business could seek to accept and manage more risk on behalf of its customers, by for example:

- improved risk management processes and expenditure optimisation; or
- a longer regulatory period (e.g. eight years) to provide price stability for customers.

Where a business has sought to transfer risk to its customer base, the business will risk a basic rating. Activities that would be consistent with a basic rating would include:

- excessively cautious contingency allowances for capital projects;
- engineering design for excessively low probability events;
- the adoption of a revenue cap with no limitations on annual price adjustments;
- increasing the fixed component of a customer’s bill; and
- uncertainty mechanisms with low threshold hurdles.

Table 4 How to rate Risk

Guiding questions	1) Expectations of a standard submission	2) Additional requirements to 1) for an Ambitious rating	3) Additional requirements to 2) for a Leading rating	4) Risk of downgrade to Basic
<ul style="list-style-type: none"> 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 has implemented a new approach that reduces prices through better risk management.	The business has implemented a new approach that reduces prices through better risk management, to a level that sets it apart from industry peers.	The business has sought to transfer risk on to customers (e.g. demand risk), which is not supported by customer views. The business has not sought to minimise price impacts from risk management.
	The business can demonstrate compliance with risk standards specified in the Statement of Obligations, such as ISO 31000.	The business has attained accreditation for these ISO standards.		The business cannot demonstrate compliance with these standards.
	The business can demonstrate that it has thoroughly evaluated the feasibility of commencement and completion dates for major projects.	The business can demonstrate a robust optimisation process that has informed what projects need to be completed, and the timing of those projects. For example, real options analysis has informed project planning.		Projects are proposed that have incomplete scope, no business cases, or are not feasible in terms of timelines for delivery.
	The business can 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.	Portfolio of contingency allowances based on higher probabilities of exceedance, of more than 50%, for example.		The business has not demonstrated that it has undertaken replicable probability analysis of the costs of all major capital projects. Portfolio of contingency allowances based on low probabilities of exceedance, of less than 50%, for example.
	The unit rates used to evaluate projects and options reflect recent historical trends, and/or independently verified market forecasts.			The business adopts assumptions that seek to maximise unit rates proposed.
	The business can support its assessment of financial viability by reference to cash flow projections and independent benchmarks (e.g. credit rating metrics).			No cash flow projections or independent support for assessment of financial viability.
	Through the form of price control and tariffs proposed, the submission seeks to appropriately balance revenue and cost risk between the business and its customers, without materially impacting on price stability.			The form of price control and/or tariffs allocate risk to customers

Inherent Limitations

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

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 Scope Section 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.

United Kingdom

Alistair Buchanan

+44 20 7694 8139
alistair.buchanan@kpmg.co.uk

Nicola Cocks

+44 20 7311 6209
nicola.cocks@kpmg.co.uk

Australia

Tim White

+61 3 9288 6436
twhite1@kpmg.com.au

Keith Lockey

+61 3 9288 5285
klockey@kpmg.com.au

kpmg.com.au