

Implementing PREMO



KPMG's recommendations

19 September 2016



What were we asked by the Commission?

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



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



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

Our approach

A framework that is:

- appropriate for the Victorian water sector;
- supported by UK precedent; and
- avoids the pitfalls experienced in other jurisdictions.

An international team of senior regulatory experts led by Alistair Buchanan, former CEO of Ofgem (responsible for designing and implementing RIIO):



UK precedent and insights – Alistair Buchanan, Nicola Cocks, Jacob Kane (KPMG LLP)



Strategic direction – Tim White, Keith Lockey (KPMG Australia), KPMG LLP



Local context – KPMG Australia



Collaboration with the ESC to ensure delivery of scope

Implementing PREMO

In providing our advice, we wanted to ensure you...

- Promote the ongoing role of customers
- Understand your responsibility for delivering outcomes that reflect customer value
- Understand the interdependencies between the PREMO elements
- Can pick up our *advice* and quickly self-assess
- Understand what is required to be graded “standard”, the additional requirements for higher ratings, or indeed the risks of being downgraded to “basic”
- Have confidence in the robustness of the framework
- Are incentivised to submit your best offer
- Avoid a “tick-the-box” exercise to meet a preferred rating
- Clearly understand and can easily respond to the proposed framework

Our recommendations



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

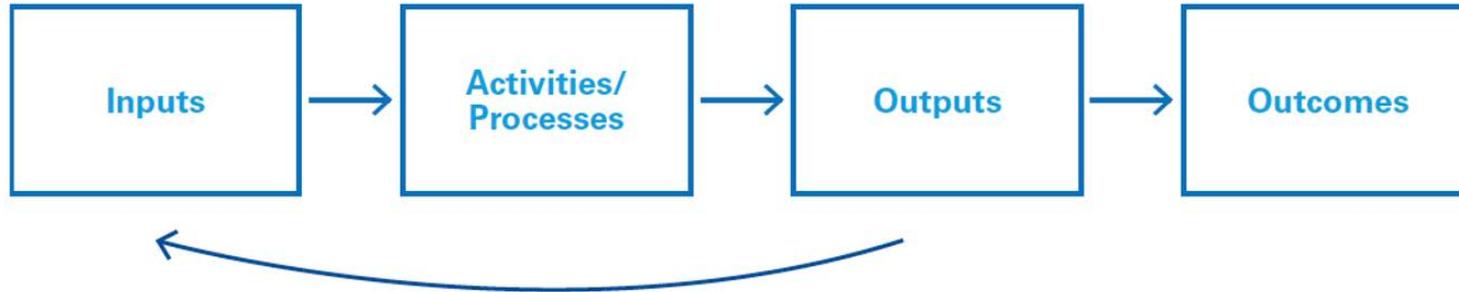
- Guiding questions for self-assessing
- the *PREMO Assessment Tool*
- sub questions
- A scoring approach
- Overall score.



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

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

Outcomes vs outputs



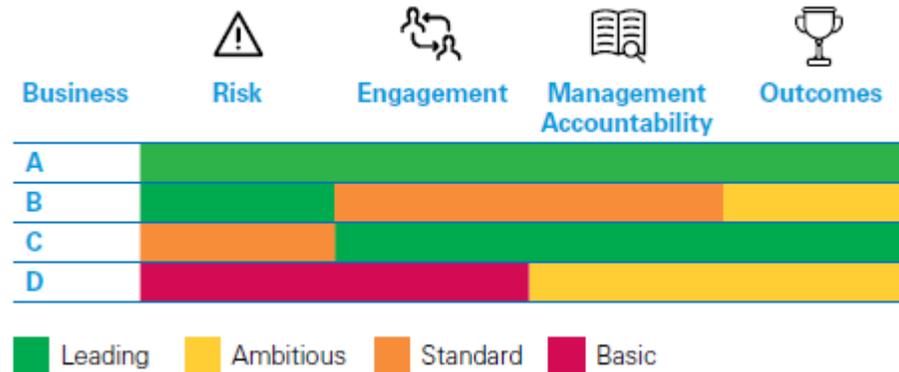
| Outcome | Output | Activity | Input |
|----------------------------|---|--|--|
| Safe, clean drinking water | <ul style="list-style-type: none"> Water quality complaints per 100 customers % compliance with ecoli | <ul style="list-style-type: none"> Mains cleaning Undertake water quality testing Upgrade TPs | <ul style="list-style-type: none"> Money Resources |



The assessment framework - scoring approach



Use a form of “traffic light” assessment of its submission against each REMO element



To determine an overall score:

- “Leading” - need to score “green” in all four REMO elements at both self-assessment and the Commission’s assessment;
- Averaging - For businesses that score a mix of ratings across the four elements.

To ensure a sensible distribution of outcomes, the Commission should undertake a comparative assessment.



Price adjustment - performance monitoring and reporting



- Utilise the Commission's existing performance reporting process to collect annual output data from each business
- Expect each business to prepare an annual report for their customers that outlines performance against what it has promised
- The Commission to retain the option to request data at any time during the regulatory period, and to audit performance data where necessary.





Price adjustment - accounting for underperformance



Where a business has consistently underperformed within the regulatory period:

- Apply a financial penalty equivalent to the difference between the return on equity determined and a return consistent with actual performance

Where a business has outperformed its rating within the regulatory period, not to apply any financial reward, unless it was “down-rated” at the margins

We did not propose any changes to the Commission’s current approach to allowing for uncertainty mechanisms



The assessment framework – guiding questions

Table: REMO assessment guiding questions

Outcomes



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

Management



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

Engagement



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

Risk



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



The assessment framework - a "standard" submission

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.



The assessment framework - *PREMO Assessment Tool*

Table: Outcomes 

| The Commission's expectations for a standard submission | Additional requirements for an ambitious rating | Additional requirements for a leading rating | Risk of downgrade to Basic |
|---|--|---|--|
| <ul style="list-style-type: none"> Outcomes broadly consistent with existing levels of service | <ul style="list-style-type: none"> Outcomes reflect a significant improvement in customer value delivered | <ul style="list-style-type: none"> Outcomes reflect a step change improvement in customer value delivered that leads the industry. | <ul style="list-style-type: none"> Proposed a degradation in customer outcomes, not justified or supported by customer feedback |
| <ul style="list-style-type: none"> Defined outcomes to reflect customer service experience | <ul style="list-style-type: none"> All outcomes are defined to reflect the customer service experience. | | <ul style="list-style-type: none"> Outcomes defined as outputs (e.g. consistent with current performance standards) |
| <ul style="list-style-type: none"> Outcomes reflect customer preferences and priorities revealed through engagement. Where outcome proposed are inconsistent, the business has sought to justify why | | | <ul style="list-style-type: none"> Outcomes do not clearly reflect customer preferences and priorities, and do not explain or justify why |
| <ul style="list-style-type: none"> Expenditure forecast to deliver outputs and reflects customer priorities. | | | <ul style="list-style-type: none"> Forecast expenditure is inconsistent with outputs proposed and does not reflect customer priorities |
| <ul style="list-style-type: none"> Proposed and justified appropriate measures and timelines to track performance | | | <ul style="list-style-type: none"> The business has not proposed appropriate measures and timelines to track performance |
| <ul style="list-style-type: none"> Committed to and described a performance monitoring and reporting process | | | <ul style="list-style-type: none"> No defined process for monitoring and reporting to customers within period performance |



The assessment framework - PREMO Assessment Tool

Table: Management accountability 

| The Commission's expectations for a standard submission | Additional requirements for an ambitious rating | Additional requirements for a leading rating | Risk of downgrade to Basic |
|---|---|---|--|
| <ul style="list-style-type: none"> Productivity improvements built into forecast expenditure at least equivalent to the Commission's 1% controllable opex efficiency hurdle | <ul style="list-style-type: none"> Proposed a significant improvement in the productivity of the services delivered. Forecast efficiency improvements > the opex efficiency hurdle | <ul style="list-style-type: none"> Step change improvement in productivity of services delivered, such that business is industry leader on cost efficiency Efficiency improvements exceed, by a very significant margin, the opex efficiency hurdle | <ul style="list-style-type: none"> Has not proposed productivity improvements. Does not meet the opex efficiency hurdle (used in 2013 water price review). |
| <ul style="list-style-type: none"> Can provide business cases and justification for all major projects and capital programs, including evidence of appropriate options analysis. | <ul style="list-style-type: none"> The business has proposed a material improvement in the efficiency of its capital program. | <ul style="list-style-type: none"> 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. | <ul style="list-style-type: none"> The business has not provided timely access to robust business cases that validate the basis for all major projects and capital programs. |
| <ul style="list-style-type: none"> Senior exec and Board acknowledge/attest, that it has undertaken appropriate internal procedures to assure themselves of the quality and accuracy of their submission | | | <ul style="list-style-type: none"> Senior executive and/or Board have not attested that it has undertaken appropriate internal procedures to assure themselves of the quality and accuracy of their submission. |
| <ul style="list-style-type: none"> The price submission addresses all requirements specified in the Commission's Guidance Paper. | | | <ul style="list-style-type: none"> The price submission does not address all requirements of the Commission's Guidance Paper |
| <ul style="list-style-type: none"> The price submission contains no material/obvious errors/omissions | | | <ul style="list-style-type: none"> The price submission contains errors and/or omissions sufficient to concern the Commission. |



The assessment framework - PREMO Assessment Tool

Table: Management accountability (cont'd) 

| The Commission's expectations for a standard submission | Additional requirements for an ambitious rating | Additional requirements for a leading rating | Risk of downgrade to Basic |
|---|---|--|---|
| <ul style="list-style-type: none"> Financial template is completed with no missing information, and consistent with the written price submission | | | <ul style="list-style-type: none"> Financial template is incomplete and/or contains inconsistent information compared to the price submission |
| <ul style="list-style-type: none"> All submission delivered to the Commission by the deadlines. | | | <ul style="list-style-type: none"> Deliverables are submitted after the deadline. |
| <ul style="list-style-type: none"> Forecasts based on sound methodologies and assumptions | | | <ul style="list-style-type: none"> Forecasting methods that biases the outcome to being beneficial to the business over customers |
| <ul style="list-style-type: none"> The price submission is 'internally consistent'; demonstrating alignment between different elements of the price submission | | | <ul style="list-style-type: none"> The price submission is contradictory across main elements of the submission. |
| <ul style="list-style-type: none"> Sought to absorb any "cost push ins" | | | |
| <ul style="list-style-type: none"> Explains mitigation strategies for customers experiencing a price shock. | | | <ul style="list-style-type: none"> Has not sought to mitigate price shock |
| <ul style="list-style-type: none"> Retains supporting documentation to justify its proposals, with ongoing access available to the Commission. | | | <ul style="list-style-type: none"> Has not provided timely access to meaningful and robust supporting documentation, on request from the Commission. |



The assessment framework - PREMO Assessment Tool

Table: Engagement

| The Commission's expectations for a standard submission | Additional requirements for an ambitious rating | Additional requirements for a leading rating | Risk of downgrade to Basic |
|---|--|---|--|
| <ul style="list-style-type: none"> • Demonstrates engagement has occurred on matters important to customers • Demonstrates engagement was undertaken early, prior to locking in key strategies and priorities • Demonstrates that business re-tested its position and proposals with customers • Form of customer engagement is fit for purpose • Demonstrate that information provided to customers was appropriate | <ul style="list-style-type: none"> • 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>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 | <ul style="list-style-type: none"> • Engagement not on matters important to customers or significant to the outcomes they receive • Engagement was undertaken late, after the price submission was developed. • Has not retested its position and proposals with customers • Failed to demonstrate that engagement elicited information that could shape the price submission. • Information written in technical jargon, and/or not appropriate for customer use |
| <ul style="list-style-type: none"> • Price submission describes what was learned from customer engagement, and how this influenced the proposal | <ul style="list-style-type: none"> • Outcomes proposed reflect a significant improvement in customer value delivered, consistent with customer priorities | <ul style="list-style-type: none"> • Outcomes proposed reflect a step change improvement in customer value delivered, consistent with customer priorities • The business proposes outcomes that lead the industry | <ul style="list-style-type: none"> • Price submission does not clearly link engagement feedback to outcomes proposed, and the alignment of outcomes to expenditure and prices |



The assessment framework - PREMO Assessment Tool

Table: Risk 

| The Commission's expectations for a standard submission | Additional requirements for an ambitious rating | Additional requirements for a leading rating | Risk of downgrade to Basic |
|--|---|--|--|
| <ul style="list-style-type: none"> Meets the requirements of the SoO and the Commission's Guidance Paper relating to risk | <ul style="list-style-type: none"> Implemented a new approach that reduces prices through better risk management | <ul style="list-style-type: none"> Reduces prices through better risk management, to a level that sets it apart from industry peers | <ul style="list-style-type: none"> Sought to transfer risk to customers, without their support, and has not minimised price impacts |
| <ul style="list-style-type: none"> Demonstrates compliance with risk standards specified in the SoO (e.g. ISO 31000) | <ul style="list-style-type: none"> Attained accreditation for these ISO standards | | <ul style="list-style-type: none"> Cannot demonstrate compliance with these standards |
| <ul style="list-style-type: none"> Demonstrates a thorough evaluation of major project delivery | <ul style="list-style-type: none"> Demonstrates a robust optimisation (e.g. real options analysis) | | <ul style="list-style-type: none"> Projects proposed have incomplete scope, no business cases, or unrealistic timing |
| <ul style="list-style-type: none"> Unit rates reflect recent historical trends, and/or independently verified market forecasts | <ul style="list-style-type: none"> | | <ul style="list-style-type: none"> Adopts assumptions that seek to maximise unit rates proposed |
| <ul style="list-style-type: none"> Demonstrates rigorous probability analysis that can be independently replicated, with contingency allowances no less than 50% prob of exceedance | <ul style="list-style-type: none"> Portfolio of contingency allowances based on higher probabilities of exceedance (>50%) | | <ul style="list-style-type: none"> Cannot demonstrate replicable probability analysis for major projects, and/or contingency based on low prob of exceedance, (<50%) |
| <ul style="list-style-type: none"> Financial viability supported by reference to cash flow projections and independent benchmarks | | | <ul style="list-style-type: none"> No cash flow projections or independent support for assessment of financial viability. |
| <ul style="list-style-type: none"> Form of price control and tariffs seek to appropriately balance risk between business and customers | | | <ul style="list-style-type: none"> Form of price control and/or tariffs seek to transfer revenue/cost risk to customers |

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