

Response to FarrierSwier's review of the 2023 Victorian water price reviews

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Introduction

In August 2024 the Essential Services Commission engaged Farrier Swier Consulting Pty Ltd (FarrierSwier) to conduct an independent review of our 2023 water price review.

The objective of this review was to:

- Assess how well the price review delivered on the objectives of the PREMO framework.
- Gain feedback on our processes and approach.

This report presents our response to the FarrierSwier report and the actions we will take.

PREMO framework

PREMO – Performance, Risk, Engagement, Management and Outcome – is the pricing framework for Victorian water businesses first introduced for our 2018 price review (see Appendix A). The framework places customers at the centre of a water business's price submission.

The commission's 2023 water price review was the second review using the PREMO framework.

Our response

The FarrierSwier report indicated strong support for the PREMO framework and the commission's overall approach. It showed that the price review process has delivered against the original PREMO objectives of customers, performance, autonomy and simplicity.¹ Consistent with this feedback, we do not propose to further review or amend the PREMO framework. Our response instead focuses on achieving the improvement opportunities identified in the FarrierSwier report related to the practical application of the PREMO framework.

This includes improvements and uplift in our own guidance, processes and timelines. It also includes engaging with water businesses to build sector-wide understanding of the framework and

¹ Farrier Swier Consulting 2024, *Review of the 2023 Victorian water price reviews: How effectively did the 2023 water price review process and outcomes deliver on the objectives of PREMO?*, August. Available on our website at: <https://www.esc.vic.gov.au/water/how-we-regulate-water-sector/premo-water-pricing-framework>

FarrierSwier also undertook an independent review of the 2018 price review process. This review found PREMO contributed significantly to delivering better outcomes for customers, and through a stronger emphasis on customer engagement, better reflected customer views. The earlier review report is also available on our website – see: Farrier Swier Consulting 2019, *Victoria's water sector: The PREMO model for economic regulation*, March.

capacity to embed the customer-centric PREMO mindset into business-as-usual practices, performance monitoring and reporting.

While this report responds broadly to the nine key findings set out in the FarrierSwier report, we acknowledge the nuanced critiques, comments and recommendations underpinning these key findings. Our proposed actions for each finding provide avenues to further explore and address these matters in collaboration with water businesses.

Engagement program

The commission will run a PREMO engagement program with water businesses (targeted at all levels from boards to regulatory staff) over the next 18 months. The program will:

- Focus on the areas identified for improvement in the FarrierSwier report.
- Support businesses' understanding of the PREMO framework.

We will also review our supporting material to ensure that it is clear and fit for purpose. The engagement program and supporting documentation review will feed into our updated guidance for the 2028 water price review.

Collaborative approach

The commission will work with the water businesses and VicWater to plan our engagement strategy. We will also explore how we can contribute to maintaining PREMO knowledge retention within the sector, including broader education programs to address board and staff turnover.

Key findings

Table 1 sets out FarrierSwier's key findings and the commission's response and proposed actions for each finding.

Table 1 Findings, response and actions

FarrierSwier review findings	Our response	Our actions
1. Strong stakeholder support for PREMO and its objectives	<ul style="list-style-type: none"> • We are greatly encouraged by this finding and the almost universal support for our PREMO framework from those involved in the FarrierSwier review. Stakeholders do not want us to move away from PREMO or make major changes to it. • Our framework was designed to be flexible and able to evolve and accommodate changes in the operating environment to ensure ongoing value for customers of all water businesses. • We note FarrierSwier's observations that improvement opportunities are related to the practical application of the PREMO framework, rather than the design of the framework itself. • On the back of the strong support expressed as part of this review for the PREMO framework and overall process, the commission has concluded that no further review into the PREMO framework is required at this time. The true success is evident in how well some businesses have grasped the concepts of PREMO and are building them into their business operations. • The commission will instead address the areas identified for improvement and focus on working with the water businesses to ensure they continue to evolve towards better achieving the four original objectives of the framework and embedding these into business-as-usual practices for the ultimate benefit of customers. 	<ul style="list-style-type: none"> • We are not proposing a further review of the PREMO framework. • We will undertake a greater level of engagement with water businesses at all levels – boards, executive teams and regulatory teams – to continue to communicate the objectives and the fundamentals of the PREMO pricing framework, the businesses' regulatory obligations, and the commission's regulatory role.
2. PREMO's Engagement element is a clear success story and has delivered on PREMO's objective to put	<ul style="list-style-type: none"> • We agree. Water businesses clearly demonstrate a greater focus on their customers and improved customer outcomes. Price proposals are expressed in terms of customer outcomes and customer value, a key objective of the PREMO framework. • Stakeholders have asked what a 'step-up' in engagement might look like. We do not expect businesses to do <i>more</i> engagement, but 	<ul style="list-style-type: none"> • We will not require an increase in engagement for future price reviews, rather a focus on appropriate engagement, tailored to the individual businesses and customers' needs.

Our response

customers at the centre of the price review process.	<p>we encourage continual refinement to improve the effectiveness of the engagement processes.</p> <ul style="list-style-type: none"> • Businesses are telling us they are benefitting from ongoing engagement with their customers into and through the regulatory period – for performance reporting and stewardship, testing for change in priorities, etc. We support this move towards incorporating engagement and consultation into business-as-usual business planning processes, rather than being solely designed for the price review process. • Annual outcomes reporting allows businesses to demonstrate whether their customers are getting what they paid for. We encourage businesses to continue to refine and expand their outcome measures and targets to better demonstrate this customer value. 	<ul style="list-style-type: none"> • We have convened two workshops to review the requirements introduced in the 2023 guidance for inclusive engagement practices with customers experiencing vulnerability and with First Nations people. • We will conduct further workshops to showcase efficient engagement programs, including hearing from businesses adopting ongoing engagement formats. • We will look to simplify and clarify our guidance and supporting documentation in advance of the 2028 price review.
3. PREMO incentivises water businesses to pursue efficiencies and make high-quality price submissions	<ul style="list-style-type: none"> • We are pleased by the finding that PREMO provides incentives to pursue efficiencies and make high-quality price submissions but that delivering good outcomes for customers is the most important incentive. • PREMO is designed to provide reputational incentives through its requirement that water businesses table their 'best offer' and self-rate their level of ambition in support of this offer. However, in preparing their price submissions, businesses should prioritise best customer value. 	<ul style="list-style-type: none"> • The PREMO framework will continue to focus on the objective of customer value, while also providing both financial and reputational incentives to reward great customer value and high-quality price submissions.
4. Fast tracking is a very effective incentive and there	<ul style="list-style-type: none"> • We recognise that the fast-track incentive is valued by businesses, and that it helps produce good quality price submissions. However, the review suggests the requirements for a pricing decision to be fast-tracked are not well understood. 	<ul style="list-style-type: none"> • We will conduct a workshop or seminar to explore the price review timeline, the flexible tailored assessment process and how the fast-tracking incentive can be better

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<p>is likely to be benefit in increasing its use</p>	<ul style="list-style-type: none"> • Rather than establishing definitive criteria, our starting position is that each price submission can be fast-tracked. In practice, we are more likely to fast-track in those instances where we can verify proposals in the price submission efficiently and effectively. This requires clear and concise proposals, and a prompt response to provide supporting evidence when requested. Businesses will also benefit by engaging early with the commission team, especially where substantial changes are being proposed. • Our framework establishes a flexible assessment process to allow for streamlined price review processes but does not lock in a specific process or fast-track timeline. We are open to explore alternative timelines and approaches to fast tracking price decisions, especially if we are to make better use of this feature at the 2028 price review of 16 water businesses. 	<p>utilised. This will include showcases from fast-tracked businesses.</p> <ul style="list-style-type: none"> • We will consider providing additional guidance about fast-tracking in advance of the 2028 price review.
<p>5. PREMO's financial incentives have not had the intended effect on businesses</p>	<ul style="list-style-type: none"> • We are disappointed that some businesses did not appear to be incentivised by the higher rates of return available through the PREMO rating system, and that they considered this a perverse incentive because it raises customer prices. • We remain committed to the financial incentive as a central part of the framework, and we want to work with businesses to improve their understanding and application. • These higher returns are not solely about higher prices but provide an opportunity for strong-performing businesses to continue to invest in improvements and further ambition to meet consumer and community needs. • An important aspect of this is shifting risk from customers to the water businesses themselves. Essentially, the business must carefully balance cost savings and service excellence that focuses on customer value, and it can secure higher financial returns where it is successful. 	<ul style="list-style-type: none"> • The PREMO framework will continue to provide a financial incentive to reward those businesses proposing and delivering ambitious customer value. • We will conduct engagement with water business boards and executive teams to ensure a robust understanding of the regulatory price setting process and the PREMO incentive mechanisms.

6. Businesses are concerned there is too much focus on short-term price impacts and insufficient attention on longer-term challenges faced by the sector, but it is unclear how much of this concern relates to PREMO
- We note businesses' concerns – there is a natural tension between water businesses needing to manage short-term cost pressures (particularly during an inflationary period) and planning for and delivering longer-term investment requirements.
 - We acknowledge that our decision to change our approach to inflation late in the price review process had an impact on businesses. But we consider this late change was necessary to counter the effects of high inflation on customer prices.
 - The 2023 and 2024 reviews took place during a period of high inflation and cost-of-living concerns. It was appropriate for the commission to interrogate businesses to ensure they were taking into account the economic climate.
 - The primary objective of the commission is the long-term interests of consumers and the PREMO framework allows for long term investment. In fact, we expect water businesses to address both short-term cost impacts and longer-term viability and sustainability matters.
 - Our framework requires proposed prices to reflect prudent and efficient expenditure forecasts, but is not prescriptive, nor restrictive, about short versus long-term objectives. This affords businesses broad scope to strike an appropriate balance between short-term pricing impacts on current customers and longer-term investment requirements for future customers.
 - We recognise a 5-year regulatory pricing period creates a focus on the short-to-medium term, but the framework allows businesses to nominate their own preferred regulatory period.
 - Price submissions are required to provide investment outlooks across at least the next 10 years. We expect businesses will use their longer-term capital investment plans to support their current investment proposals.
 - We approved 99 per cent of the total capital expenditure proposed at the recent price reviews. Businesses should feel confident proposals will be accepted where there is strong justification for their inclusion, especially where there is evidence of strong customer support.
 - We are committed to ensuring that essential services remain just, reliable and cost-effective as they respond to long-term changes, including the transition to carbon neutrality, and we recognise the challenges that water businesses are facing.
 - We included additional text in the guidance for the upcoming 2026 price reviews for Melbourne Water and North East Water related to managing risks over a long-term planning horizon, in particular risks related to climate change.
 - We will conduct engagement with water business boards and executive teams to share our views and expectations and explore (perceived) barriers to investments with a longer-term focus.
 - We will consider providing additional guidance about how to incorporate long-term investment needs into price submissions in advance of the 2028 price review.

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7. Businesses are seeking more clarity on PREMO's simplicity objective

- We understand that there are divergent views about the simplicity objective. In developing the framework, we sought simplicity over complexity where possible, encouraging businesses to focus their proposals on the more material matters affecting customer outcomes. However, we are still required to assess price submissions against the regulatory instruments, and we acknowledge that preparing a price submission to meet these regulatory requirements is a complex and resource intensive process.
- We encourage businesses to integrate the PREMO principles and price review process and their own commitments into their business-as-usual strategy and financial management processes. We consider this integrated approach to business planning and operation will reduce the burden of preparing a price submission and undertaking the price review process. This whole-of-business approach to PREMO ensures it is more than just a price review matter to be looked at every five years, and will help build knowledge resilience across the business, not just residing with a select few regulatory specialists.
- It is important to note that the commission does not associate the length of a price submission with 'simplicity'.
- We are committed to a focus on overall customer outcomes. However, given the regulatory framework, the PREMO framework does not negate the need for the price review to follow certain processes.
- We will conduct workshops with water businesses to discuss the simplicity element built into our framework and explore how to focus price submissions on the more material matters, which will also help streamline the assessment process.
- We have commenced a review of the New Customer Contributions framework in 2024, which will result in updated guidance on this ahead of the 2028 price review.
- We will ask for feedback to understand where we can streamline and better integrate our (and our consultants') assessment processes, including how we prepare our requests for further information.

<p>8. The Performance element of PREMO was effective but clearer guidance could help</p>	<ul style="list-style-type: none"> • We recognise the Performance element of PREMO was new for the 2023 and 2024 price reviews and note some businesses have requested further guidance on this. • Accountability for actual performance against benchmarks and delivery against customer commitments is very important in our customer-centred framework, effectively ‘closing the loop’ of the pricing cycle. • We are keen for water businesses to have a clear understanding of how to account for performance during the regulatory period and score their Performance element rating when preparing their price submissions. • We consider robust performance tracking and year-on-year reporting throughout the regulatory period is crucial for preparing the next price submission. In particular, tracking and understanding variance from expenditure benchmarks through the annual regulatory accounts reporting process. Commission staff have developed an expenditure tracking tool to follow this variance across the regulatory period, and we expect businesses will be doing the same. 	<ul style="list-style-type: none"> • We have provided some simple tools in the annual Regulatory Accounting Template to help identify annual variations from the benchmarks, and we will look to expand these tools. • We will conduct workshops with water businesses on performance tracking and reporting, and to determine what tools we could provide to assist with this. • We will engage with water business boards and executive teams to ensure a robust understanding of the regulatory price setting process and the PREMO incentive mechanisms. • We will consider providing additional guidance on the Performance element of PREMO in advance of the 2028 price review.
<p>9. Water businesses could give more attention to the Risk element of PREMO and tools for managing uncertainty</p>	<ul style="list-style-type: none"> • We welcome the review’s findings and expect that water businesses will need to effectively manage even greater levels of uncertainty into the future. • We expect water businesses to manage risk on behalf of their customers, rather than passing on this risk through customer prices, to address uncertainty in their forecasting. • These financial risks are generally carried until the next price review when prudent and efficient capital investment costs and increased operating costs can be included in forward prices. 	<ul style="list-style-type: none"> • We will engage with water business boards and executive teams to ensure a robust understanding of the Risk element of PREMO. • We will consider providing additional guidance on the Risk element of PREMO in advance of the 2028 price review.

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- The autonomy principle enshrined in PREMO means each business has considerable scope to propose its own approach to managing risk and uncertainty. This applies for all cost drivers, including growth and the government's housing statement, environment, climate adaptation and resilience, emissions reduction, integrated water management, etc.
- This also extends to managing the balance between short- and long-term investing, as discussed in finding 6 above.
- Re-opening a price determination to accommodate input cost increases is a very high hurdle and should be viewed as an action of last resort. There are other means for managing uncertainty, and we support businesses' greater use of these where appropriate.

We appreciate your feedback

The commission would like to thank everyone who participated in the FarrierSwier review. The findings and feedback are very valuable to us and allow us to understand water businesses' experiences of the framework and identify areas for improvement.

Further information

See our website for more information on the FarrierSwier review.

Our response

Appendix 1 – The PREMO pricing framework

The commission implemented the PREMO pricing framework for the Victorian water sector in 2018.² PREMO stands for Performance, Risk, Engagement, Management and Outcomes, and represents the five elements by which a water business must demonstrate the ambition of its pricing proposal, in terms of the outcomes for customers and the value they represent:

- Performance — have the performance outcomes to which the business committed in its price submission been met or exceeded? This is a backward-looking consideration forming a key part of the subsequent price review which commenced with the second PREMO price review.
- Risk — has the business sought to allocate risk to the party best positioned to manage that risk?
- Engagement — how effective was the business's customer engagement?
- Management — is there a strong focus on efficiency? Are controllable costs increasing, staying the same, or decreasing?
- Outcomes — do proposed service outcomes represent an improvement, the status quo, or a withdrawal of service standards?

PREMO is an incentive mechanism overlaying a standard 'building-block' regulatory pricing model, designed to elicit better quality price submissions and best-offer pricing proposals from the water businesses. PREMO links reputation and financial outcomes for water businesses to the value they deliver to their customers.

The PREMO framework was designed to make the customer, not the regulator, central to a water business's price submission. Water businesses must consult extensively with their customers before, during and after developing their price submissions, and express their proposals in terms that reflect the outcomes they will be delivering to their customers.

The incentive mechanism can provide higher rates of return to those water businesses with more ambitious proposals and receiving a higher PREMO rating. It also provides a flexible, tailored assessment process, allowing well-presented and well-justified proposals to be assessed more quickly than others leading to an earlier draft decision.

In developing the new water pricing framework, we set four high level objectives. These are:

² Essential Services Commission 2016, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, October.

1. Customers – pivot water businesses’ attention squarely towards their customers. Water businesses are expected to couch their price submissions in terms that reflect the concerns, priorities and preferences of their customers.
2. Autonomy – provide greater autonomy for water businesses, in consultation with their customers, to decide on the services to be delivered, the prices to be paid and the risks businesses assume on behalf of their customers.
3. Performance – provide new incentives for water businesses to demonstrate ambition in the delivery of services and outcomes that matter most to customers, and to deliver these as efficiently as possible.
4. Simplicity – avoid focusing on matters that make little difference to the outcomes experienced by customers by choosing simplicity whenever possible.