



ASSESSING AND RATING PREMO PRICE SUBMISSIONS

A consultation paper prepared
by Commission staff

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1 INTRODUCTION

Commission staff have prepared this consultation paper to receive feedback from water businesses on the PREMO price submission assessment and rating process for the 2018 water price review. Responses will inform the PREMO price submission assessment and rating process to be included in our guidance to water businesses for the 2018 water price review.

The Essential Services Commission (the Commission) is introducing a new approach to water pricing.¹ The 2018 water price review will be the first to incorporate PREMO, a new incentive mechanism linking reputation and financial outcomes for businesses to the quality of outcomes they deliver to their customers.²

Under PREMO, the return on equity reflected in a water business's approved prices will be linked to the level of ambition reflected in a price submission. The return on equity will increase with the level of ambition.

For the 2018 water price review, water businesses will assess the ambition of their price submission against four elements of PREMO – Risk, Engagement, Management and Outcomes. During price reviews, the Performance element of PREMO will assess how well a business delivered against the Outcomes it committed to at the previous price review. As such, the Performance element of PREMO is 'backward looking' and

¹ Link to Position Paper: <http://www.esc.vic.gov.au/document/water/32478-review-of-water-pricing-approach-position-paper/>

² Essential Services Commission 2016, *A new model for pricing services in Victoria's water sector, Position Paper*, May, pp. 36–45.

would be included for assessment at subsequent price reviews under the PREMO framework following the 2018 review.

The PREMO assessment requires a water business to rate its price submission into one of four categories of ambition: 'Leading', 'Ambitious', 'Standard' or 'Basic'. (NOTE: The Commission's Water Pricing Framework and Approach paper due for release in October 2016, will confirm the terminology for the levels of ambition).

The Commission will then assess and rate the business's price submission using the same PREMO assessment criteria. The combination of the water business's rating and the Commission's rating will determine the return on equity to be reflected in prices. A 'Leading' price submission would be allowed the highest return on equity. A 'Basic' price submission would receive the lowest return on equity.³

The Commission's May 2016 position paper noted further consultation would occur on the price submission assessment and rating process. We engaged KPMG to write a paper setting out its recommended approach to assessing and rating price submissions, based on experience of similar processes undertaken by United Kingdom economic regulators Ofgem and Ofwat.⁴ The KPMG paper was used as the basis for discussion at a workshop with water businesses held in September 2016.

This paper sets out the views of Commission staff on the approach to assessing and rating price submissions under the new PREMO framework for the 2018 water price review. We have taken into account feedback received at, and following, the September workshop.

Commission staff generally agree with the price submission assessment and rating process recommended by KPMG. In this paper, we propose minor changes to KPMG's recommended approach. These changes relate to the assessment tool that businesses and the Commission would use to rate ambition for the Risk, Engagement, Management and Outcomes elements of PREMO, and the scoring methodology used to inform the overall price submission rating.

³ For more information, see: Essential Services Commission 2016, *A new model for pricing services in Victoria's water sector, Position Paper*, May, p. 44.

⁴ The KPMG paper can be found on our website: <http://www.esc.vic.gov.au/container/water/36006-kpmg-papers-practical-application-premo-framework/>

The final PREMO price submission assessment and rating process for the 2018 water price review will be outlined in our guidance due for release in November 2016.

1.1 WE ARE SEEKING FEEDBACK

We are providing interested parties with a further opportunity to provide feedback before confirming the PREMO price submission assessment and rating process in our guidance for the 2018 water price review.

Submissions are invited by **4 November 2016**. We would prefer to receive written submissions by email to **water@esc.vic.gov.au**

You may also send submissions by mail to:

Water Team — Pricing Approach Review
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

It is our policy to publish submissions on our website. If you do not wish us to disclose information publicly, please provide a confidential version and a version that is suitable for publication.

1.2 STRUCTURE OF THIS PAPER

From here, this paper sets out the views of Commission staff on:

- the key steps in the price submission assessment and rating process (chapter 2)
- the tool that water businesses and the Commission would use to assess price submissions for the 2018 water price review (chapter 3)
- the scoring approach to rate price submissions as ‘Leading’, ‘Ambitious’, ‘Standard’ or ‘Basic’ (chapter 4), and
- the Performance element of PREMO (chapter 5).

2 OVERVIEW OF THE PREMO ASSESSMENT AND RATING PROCESS

Commission staff generally agree with the price submission assessment and rating process recommended by KPMG.⁵ Below, we have incorporated KPMG's recommended approach into the price review process to be followed by the Commission (figure 2.1). We are seeking feedback before we finalise our guidance.

In the first step, a water business prepares its price submission in accordance with the Commission's guidance. In the second step, the business assesses the ambition of its price submission for the Risk, Engagement, Management and Outcomes elements of PREMO, using the assessment tool (the proposed tool is described in chapter 3).

Informed by the assessment, the water business will rate its price submission as 'Leading', 'Ambitious', 'Standard' or 'Basic' (step 3). Our guidance will include a scoring methodology to inform how a water business aggregates its assessments against the PREMO elements into an overall price submission rating. Chapter 4 describes the scoring methodologies that we are considering.

The water business's PREMO rating and the corresponding return on equity is to be included in its price submission, along with supporting justification for the rating (step 4). The return on equity will be derived from the PREMO matrix set out in the Commission's guidance.⁶

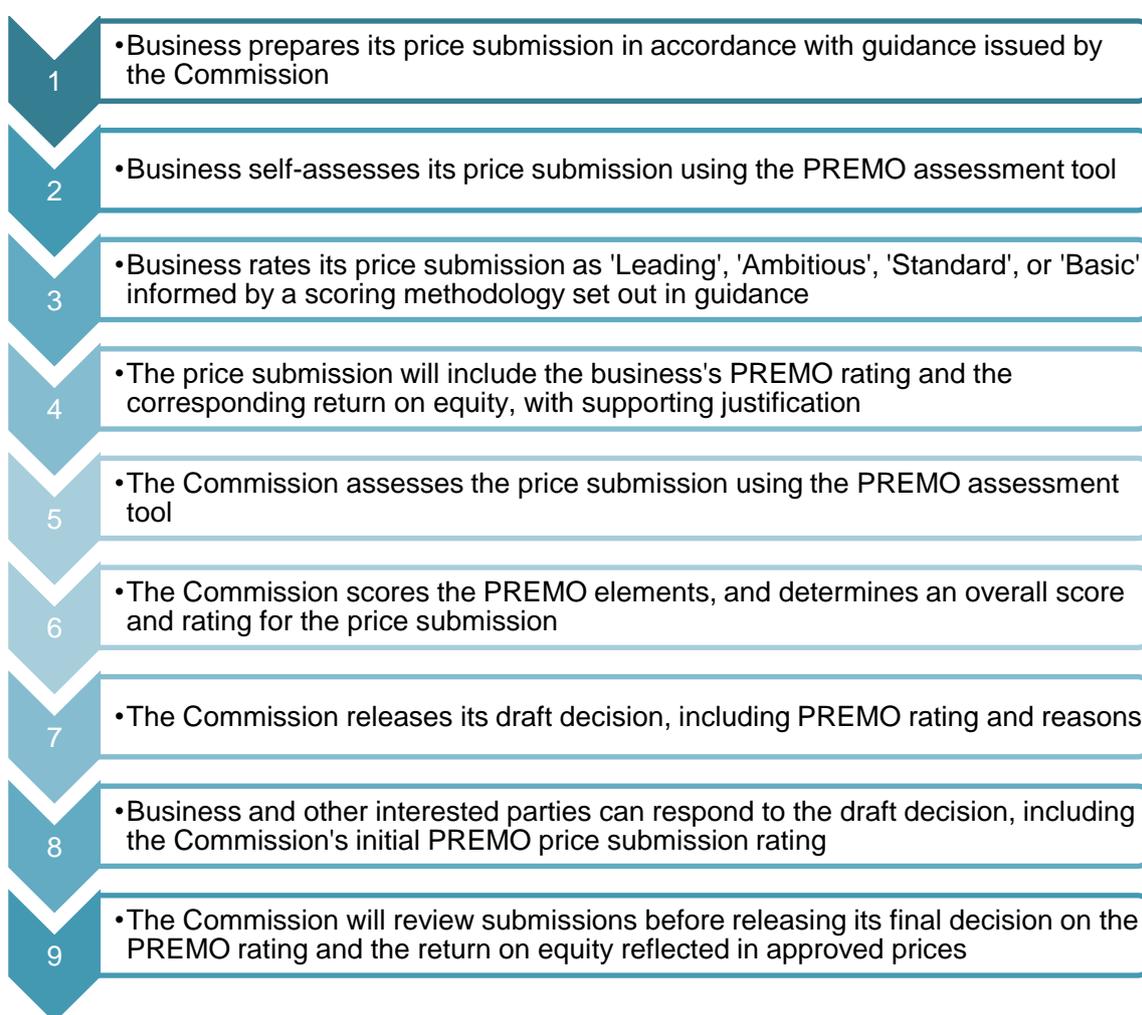
⁵ KPMG 2016, *A practical application of the PREMO framework*, September, available from the Commission's website.

⁶ For more detail on the PREMO matrix, see Essential Services Commission 2016, *A new model for pricing services in Victoria's water sector, Position Paper*, May, p. 44.

At step five, the Commission undertakes its own assessment of the price submission using the PREMO assessment tool. We would then score the price submission to rate it as 'Leading', 'Ambitious', 'Standard' or 'Basic' (step 6).

At step seven, the Commission releases its draft decision on the business's price submission. The draft decision would include our initial view of the PREMO price submission rating. Where our initial view is different to the water business, we would provide supporting reasons. As with all other aspects of the Commission's draft decision, water businesses and other interested parties would have the opportunity to respond to our initial PREMO rating before we reach a final decision (step 8).

FIGURE 2.1 PROCESS FOR RATING A PRICE SUBMISSION



A number of water businesses queried whether they will have the opportunity to reconsider the proposals in their price submission following the Commission's draft decision on the PREMO rating.

The draft decision will include the Commission's reasoning for any adjustments it may recommend to the water business's original price submission, including the business's PREMO rating. If the Commission proposes a lower PREMO rating than that proposed by the business, the business:

- **may** seek to clarify and justify its original rating by providing additional evidence in support of that rating or by seeking to demonstrate that the Commission's draft decision was in error; and
- **may not** seek to improve its rating through strengthening its value proposition to customers or by seeking to revise its submission with a lower rating to match the Commission's rating assessment.

This is because the PREMO framework requires a business to put its best offer forward in its price submission which provides an appropriate incentive for it to maximise the quality of outcomes that it proposes to deliver to Victorian water consumers. However, the draft decision will provide an opportunity for the business to propose specific criteria that might trigger an upward correction during the period, if the Commission rates the price submission at a lower level of ambition than the water business.

Consistent with our usual practice, we would also accept submissions from other interested parties on a PREMO rating and take these arguments into account.

As part of the Commission's final decision, we would include our final view on the PREMO price submission rating of each water business. This final view would take into account feedback received from interested parties prior to releasing the final decision. The Commission's final rating would determine the return on equity that is reflected in the prices approved in our price determinations (step 9).

3 PREMO ASSESSMENT TOOL

The PREMO incentive mechanism is predicated on a water business self-assessing its price submission for ambition, and then the Commission undertaking its own assessment.

During our consultation, a number of water businesses raised concerns that these two assessments might differ, resulting in adverse financial and reputational impacts for the business. Some businesses noted this could arise due to different interpretations of the criteria used to assess price submissions.

Commission staff understand that providing a reasonable degree of confidence to water businesses about the criteria is important. However, we cannot allow the self-assessment to become a ‘tick-the-box’ exercise. A key objective of PREMO is to provide stronger incentives for water businesses to put forward their best service and price offer for customers in their price submission. A ‘tick-the-box’ approach which specifies minimum standards will not provide this strong incentive.

Businesses also raised concerns that the Commission’s assessments may use measures of ‘relative’ performance — that is, we assess businesses to see where each one sits on a spectrum in comparison to its peers. These concerns stem from a perceived inequity where the Commission can use measures that are not available to the individual businesses when assessing their own proposals. On this, we note:

- Competing with others who are partially unseen is normal practice for commercial businesses operating in a competitive market. Nor is it unfamiliar to the Victorian water industry, with the principle of ‘competition by comparison’ well established in the existing framework. Moreover, in past price reviews the Commission has always compared the cost forecasts provided by a water business with those of its peers. There is no logical reason for our framework to ignore relative performance.

- The Commission will not rate a price submission lower than that proposed by a water business just because its proposals compare *relatively* unfavourably to its peers. However, where a business's proposals compare relatively less favourable to peers without any obvious explanation, it will raise questions about how critically that business has examined its own price submission (which could lead to the Commission rating the price submission lower than the business). This is similar to current practice whereby regulators use benchmarks to scrutinise business proposals.

Another matter raised by water businesses was how the PREMO assessment will take into account the starting point or existing level of ambition of a water business.

On this, we consider that the PREMO price submission assessment tool proposed in section 3.1 does not preclude a water business from making a case for its existing level of ambition to be recognised in the PREMO rating. It will be up to the water business to explain in its price submission why the PREMO rating should take into account past achievements. One example might be where a water business can clearly demonstrate it is already an industry leader on operating cost efficiency (by using externally validated benchmarking studies, for example).

We note however, that attaining a 'Leading' or 'Ambitious' price submission rating will likely require a water business to demonstrate a high level of achievement and ongoing improvements across all elements of PREMO.

From here, this chapter describes the views of Commission staff on the PREMO assessment tool for the 2018 water price review. We broadly agree with KPMG's recommendations, though we have proposed some relatively minor amendments. The proposed changes reflect our own review of KPMG's approach, and feedback received at, or following, the September workshop.

3.1 RECOMMENDED PREMO ASSESSMENT TOOL

The PREMO assessment tool would be used by the water businesses and the Commission to rate price submissions. For each of the Risk, Engagement, Management and Outcomes elements of PREMO, the tool provides:

- A set of guiding questions for water businesses and the Commission to rate price submissions. The purpose of the guiding questions is to shape the nature of evidence or justification needed to support a price submission rating.
- Examples of what might demonstrate a level of ambition consistent with each PREMO price submission rating (i.e. what might constitute the expected level of ambition for a 'Leading', 'Ambitious', 'Standard' or 'Basic' price submission).

The assessment tool does not list all examples of what may be taken into account by a water business or the Commission in arriving at a price submission rating.

As noted above, a prescriptive check-list would not provide strong incentives for a water business to put forward its best service and price offer in a price submission or to pursue innovation. Further, a prescriptive check-list would not sufficiently account for the diversity of water businesses and their customers. There may be many ways a water business might demonstrate it has a 'Leading' or 'Ambitious' price submission that are not countenanced by a check list issued by the regulator. The examples in the assessment tool are a guide.

It is important to note that the Commission will assess a water business's reasoning for its price submission rating. This reasoning must be provided in price submissions.

The tool is provided in tables 3.1, 3.2, 3.3 and 3.4 in the following pages. We have marked our proposed additions or major changes to the KPMG recommendations in **blue**. We are seeking feedback on the PREMO assessment tool.

TABLE 3.1 OUTCOMES

Guiding questions	Examples for a Standard submission	Examples for an Ambitious submission	Examples for a Leading submission	Examples for a Basic submission
<p>Has the business provided evidence that the outcomes proposed have taken into account the views, concerns and priorities of customers?</p> <p>Has the business provided sufficient explanation of how the outcomes it has proposed align to the forecast expenditure requested?</p> <p>Has the business proposed outputs to support each of its outcomes, which are measurable, robust and deliverable?</p>	<p>The outcomes proposed are broadly consistent with existing levels of service provided to customers.</p>	<p>The outcomes proposed reflect a significant improvement in customer value delivered. This might be demonstrated by significant improvements in output targets (or performance measures) for outcomes that matter most to most customers.</p> <p>The business proposes outcomes that are well ahead of the industry average or past performance (measured by reference to output targets).</p>	<p>The outcomes proposed reflect a very significant improvement in customer value delivered.</p> <p>The business proposes outcomes that lead the industry.</p>	<p>The business has proposed degradation in customer outcomes, not justified or supported by customer feedback.</p>
<p>Has the business justified that the outputs it has proposed align with the outcomes?</p>	<p>The outcomes proposed have mostly been defined in ways that reflect the customer service experience (e.g. safe, clean water supply).</p>	<p>All outcomes proposed have been defined in ways that reflect the customer service experience.</p>		<p>Most outcomes are defined as outputs (that is, at a granular level consistent with practice in the 2013 water price review).</p>
<p>Has the business demonstrated a reporting and stewardship process to measure performance against each outcome and to inform customers?</p>	<p>The business has proposed outputs that are robust measures of performance for each outcome proposed.</p>			<p>Outputs proposed are not appropriate measures of performance for the proposed outcomes.</p>
	<p>The outcomes proposed generally reflect customer preferences and priorities revealed through engagement.</p>	<p>The outcomes proposed have been prioritised by a water business in terms of importance to customers as revealed through customer engagement, and the business’s expenditure forecasts reflect the prioritisation of outcomes.</p>		<p>The outcomes proposed do not clearly reflect customer preferences and priorities revealed through engagement.</p>

Continued on the following page

TABLE 3.1 OUTCOMES

Guiding questions	Examples for a Standard submission	Examples for an Ambitious submission	Examples for a Leading submission	Examples for a Basic submission
	Where applicable, the business has explained or justified why outcomes proposed are not consistent with customer preferences and priorities.			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 outcomes proposed.			The level and composition of forecast expenditure is inconsistent with the outcomes proposed.
	The expenditure profile has changed where required to reflect customer priorities.			The expenditure profile has not changed to reflect customer priorities.
	The business has committed to and described a process for monitoring and reporting to customers on their performance against outcomes.	<p>Engagement with customers has led to the development of a customer performance reporting approach that is targeted to customer needs, including across different regions and customer types.</p>		No defined process for monitoring and reporting to customers within period performance against outcomes.
		<p>The performance reporting approach is justified as being well ahead of peers in terms of accessibility, transparency and information provided to customers on performance.</p>		

TABLE 3.2 MANAGEMENT

Guiding questions	Examples for a Standard submission	Examples for an Ambitious submission	Examples for a Leading submission	Examples for a Basic submission
<p>To what extent has the business demonstrated how its proposed prices reflect only prudent and efficient expenditure?</p> <p>To what extent has the business justified its commitment to cost efficiency or productivity improvements?</p>	<p>The price submission assumes cost efficiency 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 significant improvement in the cost efficiency of the services delivered.</p> <p>Forecast cost 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 very significant improvement in the cost efficiency of the services delivered.</p> <p>Forecast cost 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).</p>	<p>The business has not proposed productivity improvements.</p> <p>The business does not meet the Commission's one per cent controllable operating expenditure efficiency hurdle (used in 2013 water price review).</p>
<p>To what extent have senior management, including the Board, demonstrated ownership and commitment to the proposals in its submission?</p>		<p>The operating expenditure efficiency improvement is clearly above the industry benchmark.</p>	<p>The rate of improvement in operating cost efficiency places the business as a leader in the industry.</p>	
<p>To what extent has the business justified or provided assurance about the quality of the submission, including the quality of supporting information on forecast costs or projects?</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 operating expenditure forecast places the business well ahead of the industry average in terms of cost efficiency.</p>	<p>The level of operating cost efficiency places the business as a leader 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>To what extent has the business provided evidence that there is senior level, including Board level, ownership and commitment to its submission and its outcomes?</p>		<p>The business has proposed a significant improvement in the efficiency of its capital program.</p>	<p>The rate of improvement in capital expenditure efficiency places the business as a leader in the industry.</p>	<p>The business has not proposed efficiency improvements in relation to its capital renewals program.</p>

Continued on the following page

TABLE 3.2 MANAGEMENT

Guiding questions	Examples for a Standard submission	Examples for an Ambitious submission	Examples for a Leading submission	Examples for a Basic submission
	The senior executive team and Board of Directors acknowledge and can attest, (e.g. through some form of "Responsibility Statement", or a statutory declaration), that it has undertaken appropriate internal procedures to assure themselves of the quality and accuracy of their price submission.			The 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.
	The price submission addresses all requirements specified in the Commission's Guidance Paper.			The price submission does not address all requirements set out in the Commission's Guidance Paper
	The price submission and its supporting documents contain no material or obvious errors or omissions.			The price submission and its supporting documents contain errors and/or omissions of sufficient concern to the Commission.
	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 inconsistent with the price submission.
	The price submission and supporting information are provided to the Commission by the time requested.			Deliverables are submitted after the deadline.
	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.

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TABLE 3.2 MANAGEMENT

Guiding questions	Examples for a Standard submission	Examples for an Ambitious submission	Examples for a Leading submission	Examples for a Basic submission
	<p>Forecasts for expenditure (including benchmarks for labour, energy and construction costs) and demand are based on sound methodologies and assumptions.</p> <p>The business has sought to mitigate the cost and price impacts of new obligations, whether imposed by government, or to address a new customer service priority revealed through engagement.</p> <p>The business has proposed adequate mitigation strategies to avoid any price shocks.</p> <p>The business retains supporting documentation to justify its proposals, with ongoing access available to the Commission.</p>	<p>The business has absorbed cost and price impacts of new obligations, so that customer prices do not increase.</p>		<p>The business has adopted a forecasting method that biases the outcome to being beneficial to the business over customers.</p> <p>The business has not sought to mitigate the cost and price impacts of new obligations, whether imposed by government, or to address a new customer service priority revealed through engagement.</p> <p>The business has not proposed adequate mitigation strategies to avoid any price shocks.</p> <p>The business has not readily provided timely access to meaningful and robust supporting documentation, on request from the Commission.</p>

TABLE 3.3 ENGAGEMENT

Guiding questions	Examples for a Standard submission	Examples for an Ambitious submission	Examples for a Leading submission	Examples for a Basic submission
<p>To what extent has the business justified how the form of engagement suits the content of consultation, the circumstances facing the water business and its customers?</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 onus is on each water business to make the case as to why they might rate their customer engagement as ambitious or leading. This justification could be based on:</p>		<p>The form of customer engagement is not justified as being fit for purpose given the content and circumstances facing the business and its customers.</p>
<p>To what extent has the business demonstrated that it provided appropriate instruction and information to customers about the purpose, form and content of the customer engagement?</p>		<ul style="list-style-type: none"> • Unbiased feedback from a representative group of customers about the business’s choice of engagement method and the quality of the engagement program it delivered. For example, do customers believe they were given appropriate information and time to learn about the issues, form opinions, and influence the business’s proposals? • Participants in the engagement program provide feedback that the business has delivered on the engagement commitments given by the business (e.g. on what matters would participants provide feedback on, and the influence they would have on the decisions of the business). • The level of customer influence on proposals. A strong alignment between a business’s proposals and the preferences and interests elicited in its engagement program would correspond to a higher rating. 		
<p>To what extent has the business demonstrated that the matters it has engaged on are those that have the most influence on the services provided to customers and prices charged?</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>Information provided to customers was written in technical jargon, and/or was not appropriate for customer use.</p>
<p>To what extent has the business explained how it decided when to carry out its engagement?</p>				<p>The business provided selective or incomplete information to customers that biased the responses or did not provide sufficient context for customer input.</p>
<p>To what extent has the business demonstrated how its engagement with customers has influenced its submission?</p>	<p>The business demonstrates that engagement has occurred on matters that customers reveal are the most important to them.</p>			<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>

Continued on the following page

TABLE 3.3 ENGAGEMENT

Guiding questions	Examples for a Standard submission	Examples for an Ambitious submission	Examples for a Leading submission	Examples for a Basic submission
	<p>A business demonstrates that engagement was undertaken early, prior to locking in key strategies and priorities.</p> <p>A business demonstrates it used engagement methodologies that elicit views that are representative of the customer base.</p> <p>A business demonstrates that the business re-tested its position and proposals with customers as it developed its price submission.</p> <hr/> <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> <hr/> <p>In any instances where outcomes proposed are not consistent with customer views, the business provides reasonable justification.</p>			<p>Engagement was undertaken late, after the business had developed its key strategies and priorities.</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>The business has not retested its position and proposals with customers as it developed its price submission.</p> <hr/> <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> <hr/> <p>The business cannot provide reasonable justification for instances where its proposed outcomes are not consistent with customer views.</p>

TABLE 3.4 RISK

Guiding questions	Examples for a Standard submission	Examples for an Ambitious submission	Examples for a Leading submission	Examples for a Basic submission
<p>To what extent has the business demonstrated a robust process for identifying risk, and how it has decided who should bear these risks?</p>	<p>The business meets the requirements of the Statement of Obligations and the Commission’s Guidance Paper in relation to risk.</p>	<p>The business has implemented a new approach that reduces prices through better risk management.</p>	<p>The business has implemented a new approach that reduces prices through better risk management, to a level that sets it apart from industry peers.</p>	<p>The business has sought to transfer risk on to customers (e.g. demand risk), which is not supported by customer views.</p>
<p>To what extent does the proposed guaranteed service level (GSL) scheme provide incentives for the business to be accountable for the quality of services delivered, and provide incentives to deliver valued services efficiently?</p>	<p>The business demonstrates compliance with risk standards specified in the Statement of Obligations, such as ISO 31000 and ISO 55000.</p>	<p>The business has attained accreditation for these ISO standards.</p>		<p>The business has not sought to minimise price impacts from risk management.</p>
	<p>The business can demonstrate that it has thoroughly evaluated the feasibility of commencement and completion dates for major projects.</p>	<p>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.</p>		<p>Projects are proposed that have incomplete scope, no business cases, or are not feasible in terms of timelines for delivery.</p>
	<p>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.</p>	<p>Portfolio of contingency allowances based on higher probabilities of exceedance, of more than 50%, for example.</p>		<p>The business has not demonstrated that it has undertaken replicable probability analysis of the costs of all major capital projects.</p>
				<p>Portfolio of contingency allowances based on low probabilities of exceedance, of less than 50%, for example.</p>

Continued on the following page

TABLE 3.4 RISK

Guiding questions	Examples for a Standard submission	Examples for an Ambitious submission	Examples for a Leading submission	Examples for a Basic submission
			<p>In its price submission, the business proposes correction mechanisms to adjust the return on equity where its performance does not meet the outcomes established at the price review.</p>	
	<p>The business has proposed a GSL scheme that reflects the main service concerns and priorities of customers.</p>	<p>The business has refined its GSL scheme to provide greater service accountability to customers, or to provide increased incentives to deliver services efficiently.</p>		<p>The business has not proposed a GSL scheme that reflects the main service concerns and priorities of customers.</p>
		<p>The business has proposed a GSL scheme that compares favourably to industry peers in terms of incentives to deliver services efficiently.</p>		
	<p>The unit rates used to evaluate projects and options reflect recent historical trends, and/or independently verified market forecasts.</p>			<p>The business adopts assumptions that seek to maximise unit rates proposed.</p>
	<p>The business can support its assessment of financial viability by reference to cash flow projections and independent benchmarks (e.g. credit rating metrics).</p>	<p>The water business has had its financial position review by an independent credit ratings agency.</p>		<p>No cash flow projections or independent support for assessment of financial viability.</p>
	<p>Through the form of price control and tariffs proposed, the submission appropriately balances revenue and cost risk between the business and its customers, without materially impacting on price stability.</p>			<p>The form of price control and/or tariffs over allocates risk to customers.</p>

4 PROCESS TO ESTABLISH A PREMO RATING

For the 2018 water price review, the Risk, Engagement, Management and Outcomes elements of PREMO will be assessed and then rated into one of four categories of ambition: 'Leading', 'Ambitious', 'Standard' or 'Basic'.

This chapter sets out options for a scoring methodology to guide how a water business aggregates its assessment against each of the PREMO elements into an overall price submission rating.

4.1 RATINGS

Using the assessment tool as a guide (chapter 3), the Risk, Engagement, Management and Outcome elements of PREMO will be allocated a score, depending on whether the element is rated as 'Leading', 'Ambitious', 'Standard' or 'Basic'. The component scores will be aggregated to inform a PREMO price submission rating.

The Commission will assess a water business's reasoning for its price submission rating. In other words, the score on its own is not justification for a particular price submission rating.

It is not our expectation that businesses rate or allocate a score against all the matters listed in the PREMO assessment tool (chapter 3), which are provided as examples of the matters that should be taken into account. Rather, these examples should be used to guide the rating or score for each of the Risk, Engagement, Management and Outcome elements of PREMO.

4.2 WEIGHTING

For the first review under the new framework, the Commission will not provide any criteria for the Performance element of PREMO given this element is a ‘backward looking’ assessment. It will be an element for assessment at price reviews subsequent to the 2018 review, and is discussed at chapter 5.

For the 2018 water price review, we propose that the four remaining elements — Risk, Engagement, Management and Outcomes — will be weighted evenly to establish a PREMO price submission rating.

4.3 SCORING METHOD

Below, we outline two alternative approaches to the scoring method. We are seeking feedback from water businesses on these alternatives before issuing guidance for the 2018 water price review.

4.3.1 KPMG RECOMMENDATION

KPMG recommended that after using the assessment tool, a water business rates each of the Risk, Engagement, Management and Outcome elements of PREMO as ‘Leading’, ‘Ambitious’, ‘Standard’ or ‘Basic’. A score would then be allocated to each element depending on the rating.

A score of ‘4’ would correspond with the highest ambition level, ‘Leading’. A score of ‘1’ corresponds with the lowest ambition level, ‘Basic’. An overall rating would be calculated by averaging the score across the four elements.

Table 4.1 summarises how each rating aligns with a traffic light scoring system under KPMG’s approach. It also shows the average score required to reach a certain level of ambition for the overall price submission.

TABLE 4.1 KPMG'S SCORING SYSTEM FOR A PREMO RATING

Rating	Traffic light colour	Score to be allocated to REMO elements	Average score for an overall PREMO rating
Leading	Blue	4	4
Ambitious	Green	3	3 – 3.99
Standard	Yellow	2	2 – 2.99
Basic	Amber	1	1 – 1.99

KPMG recommended that in undertaking its assessment, the Commission would also check its ratings by comparing across other price submissions to ensure it has applied the PREMO assessment tool consistently. Table 4.2 provides examples of how the Commission could release the results of its PREMO price submission assessments in its draft decision.

TABLE 4.2 EXAMPLE OF PREMO RATINGS

Business	Risk	Engagement	Management	Outcomes	Overall Score
A	4	4	4	4	4
B	3	3	3	4	3.25
C	2	2	3	3	2.5
D	2	1	3	1	1.75

Business A's price submission would be rated as 'Leading', as the price submission achieved a 'Leading' rating across all four elements. Business B would be rated as 'Ambitious' as its score fell within the 3–3.99 range in table 4.1. Business C would receive a 'Standard' rating for its price submission as its score fell within the 2–2.99 range. Business D would be rated as 'Basic', with an overall score below 2.

4.3.2 ALTERNATIVE SCORING METHOD

An alternative method proposed by Commission staff builds on KPMG’s recommended approach. Under KPMG’s proposal, the scoring system only allows a business to assign one possible number to each element of PREMO, depending on the assessment of ambition. For example, only a score of ‘3’ can be given to an element of PREMO rated as ‘Ambitious’.

Our concern with this approach is that it does not allow a water business or the Commission to express the degree of confidence that an element of PREMO meets the nominated level of ambition. This may lead to businesses or the Commission being overly conservative or optimistic in arriving at a rating.

As an alternative to the KPMG approach, we propose a graded scoring system that distinguishes, to some extent, the confidence with which a business or the Commission considers an element of PREMO meets a particular ambition rating.

Table 4.3 summarises possible scores for each element of PREMO graded by confidence level. The component scores for each element of PREMO would be aggregated to inform an overall price submission rating. Table 4.3 also shows the aggregate score range for each PREMO rating that would reflect the overall level of ambition for the price submission. However, under this approach it may be possible for the scoring system to indicate a water business’s price submission is ‘Standard’ for example, despite rating up to three of the PREMO elements as ‘Basic’. The scoring approach might be too strict, particularly for the first round of assessments.

Therefore, if we proceed with the graded scoring approach, we would also include additional scoring rules. For example, the rules could incorporate a requirement that to achieve a ‘Standard’ rating for the price submission, no PREMO element could be rated below the ‘Standard’ range from 1.75 to 2.5. The same approach would apply to other levels of ambition.

TABLE 4.3 ALTERNATIVE SCORING SYSTEM FOR A PREMO RATING

Rating	Traffic Light Colour	Possible scores for each element of PREMO		Aggregated score for overall PREMO rating*
Leading	Blue	4	Very confident the price submission is 'Leading'	15.5 to 16
		3.75	Confident the price submission is 'Leading'	
Ambitious	Green	3.5	Very confident the price submission is 'Ambitious'	11.5 to 15.25
		3.25	Confident the price submission is 'Ambitious'	
		3	Satisfied the price submission is 'Ambitious'	
		2.75	Reasonably confident the price submission is 'Ambitious'	
Standard	Yellow	2.5	Very confident the price submission is 'Standard'	7.5 to 11.25
		2.25	Confident the price submission is 'Standard'	
		2	Satisfied the price submission is 'Standard'	
		1.75	Reasonably confident the price submission is 'Standard'	
Basic	Amber	1.5	Very confident the price submission is 'Basic'	4 to 7.25
		1.25	Confident the price submission is 'Basic'	
		1	Satisfied the price submission is 'Basic'	

As per section 4.3.1, the Commission would also use the same scoring system to rate price submissions. The Commission would check the consistency of its ratings across all price submissions to ensure all businesses have been rated fairly.

Table 4.4 provides examples of how the Commission could release the results of its PREMO price submission assessments in its draft decision. Business A's price submission would be 'Leading' (with an aggregated score above 15.5). Business B's price submission would be rated as 'Ambitious' (with an aggregated score within the 'Ambitious' score range of 11.5 to 15.25). Business C's price submission would be 'Standard', and Business D's price submission would be 'Basic'.

TABLE 4.4 EXAMPLE OF PREMO RATINGS

Business	Risk	Engagement	Management	Outcomes	Total Score
A	3.75	4	4	4	15.75
B	2.75	3	3	3.75	12
C	2.5	2	3.25	1.75	9.5
D	1.50	1.50	1.50	2.00	6.50

We are seeking feedback on the options for a scoring system before finalising our guidance, due for release in November 2016.

5 THE PERFORMANCE ELEMENT OF PREMO

As mentioned earlier, for the 2018 water price review, water businesses will assess their price submission against criteria for four elements of PREMO — Risk, Engagement, Management and Outcomes. The Performance element is ‘backward looking’ and would be included for assessment at subsequent price reviews under the PREMO framework following the 2018 review.

Linking a business’s performance against its outcome commitments to the price submission rating and allowed return on equity will provide a new incentive for water businesses to be accountable for their service commitments to customers.

This chapter describes — at a high level — the views of Commission staff on how the Performance element of PREMO would be assessed at price reviews subsequent to the 2018 review. We may also assess how accurate estimates or forecasts have been (linked to the Management element of PREMO).

The Performance element of PREMO will take into account the performance of a water business in delivering the Outcomes (the “O” element of PREMO) established in the previous price review.

The Performance element will be rated as ‘Leading’, ‘Ambitious’, ‘Standard’ or ‘Basic’ alongside the other four PREMO elements to inform a price submission rating and the return on equity reflected in approved prices.

A water business would undertake the following high level steps to arrive at a rating for the Performance element of PREMO:

- For each outcome specified at the previous price review, a water business would assess whether it exceeded, met, or fell short of the measures of performance for the outcome.¹
- Using the assessment for each outcome, a water business would assess whether its overall performance exceeded, met, or fell short of its performance targets to inform a Performance rating.

This process should be relatively straightforward for water businesses given there will be a requirement in the pricing approach for them to report annually to customers on how they are performing relative to their outcomes.

The process will require water businesses to make the case for their stated level of performance against outcomes. As with other elements of PREMO, while the assessment framework should be as objective as possible, there may be a degree of judgement required as to whether Performance is rated as ‘Leading’, ‘Ambitious’, ‘Standard’ or ‘Basic’. For example, a water business may have exceeded performance measures for some but not all outcomes, or it may have exceeded them in some years and not others. A business may perform well on matters that are of most importance to customers, and not as well against others.

The Commission would also rate Performance following the high level steps above. We will also take into account how well a water business informed its customers on its performance during the previous pricing period, and how it addressed any performance shortfalls.

The steps for rating Performance also need to take into account the level of ambition in the outcomes specified at the previous price review. For example, a water business that set more ambitious performance targets for Outcomes than other businesses should have this taken into account in the Performance assessment.

Consequently, the Performance rating for each business would be contingent on the rating for the Outcomes element of PREMO established at the previous price review.

One possible approach is illustrated in table 5.1. For example, the table shows that if a water business’s Outcomes are rated as ‘Ambitious’ at the 2018 water price review, and it meets the specified performance targets, the business’s Performance element of

¹ The Commission’s new pricing framework requires water businesses to develop, in consultation with customers, specific measurable outputs and deliverable targets to define successful delivery of each outcome. Businesses must report performance against these targets on a regular basis throughout the regulatory pricing period.

PREMO would be rated as ‘Ambitious’ at the review following 2018. If performance exceeded the standards expected, the Performance element would be rated as ‘Leading’.

TABLE 5.1 EXAMPLE OF RATING PERFORMANCE AT THE PRICE REVIEW SUBSEQUENT TO THE 2018 REVIEW

Outcomes rating from 2018 price review	Performance rating at price review following 2018 review		
	<i>Exceeded outcomes set in 2018</i>	<i>Met outcomes set in 2018</i>	<i>Fell short of outcomes set in 2018</i>
Leading	Leading	Leading	Ambitious/Standard/Basic
Ambitious	Leading	Ambitious	Standard/Basic
Standard	Ambitious	Standard	Basic
Basic	Standard	Basic	Basic

5.1 WITHIN PERIOD PRICE CORRECTIONS

Our May 2016 position paper stated that there may be limited circumstances where the final approved PREMO rating and the corresponding return on equity may be changed during a pricing period to reflect actual performance relative to the stated outcomes. The Commission may decide to downgrade the PREMO rating and the return on equity during a pricing period where a business fails to deliver the outcomes proposed, and does not provide adequate explanation or alternative arrangements to its customers.

Given the prices charged by a water business presuppose customers will receive the level of service established in the business’s proposed outcomes, the mechanism is a way to protect customers from ongoing and material shortfalls in performance during a pricing period.

There may also be instances where outperformance could result in an upward correction to the return on equity within a pricing period (but only if the Commission rated a price submission lower than the water business). More details on the mechanism will be provided in the Commission’s upcoming Water Pricing Framework and Approach paper (due for release in October 2016).

Any within period adjustment applied by the Commission may be taken into account in assessing the Performance element of PREMO at the next price review.