From:	Geoff Phillips
To:	Water2020
Subject:	Consultation on the outcomes framework for PR19
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To OFWAT
Outcomes Consultation
Water 2020
From Mr G.H.Philllips, Plymouth, Devon
Customer of South West Water

In response to your consultation I am limiting my response to general comments on the use of rewards as incentives.

Firstly, I must stress that I view the proposal to encourage outperformance as nothing more than a cynical attempt to enhance company profits. Outperformance that results in increased bills is of no advantage to consumers. Once the agreed service standards are achieved then further improvement is unnecessary 'gold plating' that consumers do not want.
I view your proposal as an indicator of your bias and obsession with enhancing company profits.

Investment
I challenge your assertion that there is demonstrable relation between the level of incentives and the reward for capital invested. The critical issue is the level of cover, from consumers, for debt interest payment as this determines the cost of debt. Reward for shareholders is irrelevant as shareholders are NOT providing the investment funds.
It is a consequence of the regulatory process in the water sector that the value of the capital invested (RCV) is guaranteed. This value is underwritten by consumers and the water companies have realised that this can be used as collateral. Thus, any loan set against the RCV is to all intents and purposes a zero-risk loan and commands a very low interest rate.
Companies have no reason to request or take funds from shareholders.
Shareholders have no part to play in the investment process.
If a company becomes insolvent, any replacement company will be required to purchase the infrastructure assets at the RCV value. The outgoing company will therefore be able to repay all debts without recourse to shareholders.
Note that the shareholders of a limited company, by definition, have no liability to creditors beyond the value of the company's assets.
Shareholders cannot be compelled reimburse creditors. However, in the regulated water sector customers can be compelled to reimburse creditors, all be it indirectly, by increasing charges to reward the incoming company.
The RCV is a primary determinant of customer charges. Customers have no option and are required by law to pay the charges that guarantee the RCV.
If the RCV based charges are not sufficient to enable an incoming company to operate services, OFWAT must increase charges. Therefore, all risk lies with consumers, shareholders have no liability and the current obscenely excessive levels of profit are totally unjustified.

Game Theory and Cherry Picking.
Consumers and companies have very different viewpoints on the potential outcomes. Once the rules are set the companies are the only players in the game that can choose a playing strategy.
For a consumer, the only satisfactory outcome is where the company meets all targets with no out performance.
Falling short of any one of the targets is clearly bad from a consumer's viewpoint. So also, is out-performance on any target as that will trigger a reward for the company and will result in an increase in future bills.

Failing to meet a target may result in a penalty and a reduction in future bills but this will still be viewed as an undesirable outcome that needs to be avoided.
For a consumer keeping bills to a minimum is a primary concern. An uplift to bills is only acceptable where this is necessary to reach a required standard. Once that standard has been achieved then further improvement or 'gold plating' of the service that results in increased bills is a situation to be avoided.
For a company, failing to achieve a target is undesirable as this will result in a penalty. Meeting a target is neutral. Exceeding a target and earning a reward is highly desirable.
The obvious strategy for a company to play is to Cherry-pick. To invest for outperformance on all target outcomes is likely to be too expensive. Also, some required targets may be very expensive to achieve and others may be quite easy and or inexpensive to meet.
Thus, the optimum outcome for a company will be to invest just sufficient resources to avoid an expensive penalty on the difficult and expensive targets and to concentrate their remaining resources on a few easier targets to gain a maximised outperformance reward. In the case where a company has one or more very expensive targets the optimum strategy may tempt the company to accept penalties on these knowing that the resources so saved means a greater gain can be achieved by allocating them for outperformance on other easier targets.
The latter would be a highly undesirable outcome for consumers and I suggest must be avoided at all costs.
The best means to avoid deleterious Cherry Picking will be to introduce a rule whereby no reward can be earned if the company fails to achieve all targets.
The probability of achieving the consumers desirable state whereby all targets are met with no significant outperformance can be further enhanced by making the penalty reward balance asymmetric. By making the penalty slope steeper and higher than the reward slope. Thus, forcing the companies to concentrate on meeting all targets.

Setting the rules of the game.
One problem with any incentive scheme is identifying the factors that the player is able to directly influence by their actions. It is important to avoid rewarding a player for outcomes that are either random or not actually under the player's influence. A specific case is the influence of the weather and of rainfall in particular, on water supply resilience.
It makes no sense to reward a company for 100% resilience in year that has seen heavy rainfall or to apply a penalty in a drought year. This is a very long term issue and droughts are rare events.
A simple gaming strategy for a company could be to do nothing on the basis that the rewards earned for the wet years will outweigh the penalties from the relatively rare dry years. Application of this type of strategy would be a disaster for consumers as they will have been paying a premium for protection that is absent. Designing an incentive scheme to counter such a strategy is difficult and the only option is likely to be to make the penalty for failure extremely severe even to the extent of withdrawal of the supply licence.
Instead the incentives should concentrate on how the company deals with supply interruptions. Supply interruptions due to burst pipes are inevitable and the relevant factor is not that the burst happens but how rapidly supplies are restored.
An incentive relating to avoidance of hosepipe bans or other water saving measures would be counterproductive. It would not be to consumers advantage if a company delayed declaring a ban in the hope of avoiding a penalty as this could lead to worse problems later in the year.

Summary

1)I urge you to apply a rule that requires a company to achieve all targets before an outperformance reward can be claimed.
2)To discourage excessive manipulation of the incentives schemes the penalty/reward balance must be biased so that the penalty for failures is much more severe than the reward for outperformance.
3)You must ensure that the incentives are restricted to outcomes where companies have direct active control.
