

Service incentive mechanism (SIM) for 2015 onwards – a consultation

Consultation closing date 31st January 2014

Severn Trent Water Response, 31st January 2014

Consultation details

Areas under review

The purpose of this document is to consult on Ofwat's options to changing the details of the Service Incentive Mechanism (SIM) and its mode of application for 2015-2020.

The consultation opened on 14th October 2013 and closes on 31st January 2014. Ofwat plans to publish decisions on the design of SIM in March 2014.

Severn Trent Water is pleased to have the opportunity to pass comment and input in to Ofwat's consultation documentation.

Introduction

We are wholly supportive of Ofwat's reasons for evolving the Service Incentive Mechanism to reflect changes in customer expectation and channels of communication, furthermore the differing choices and services that will become available for household and non household customers in England and Wales.

The release of the 'UKCSI January 2014 - The state of customer satisfaction in the UK' serves as a timely reminder that customers want more; choice, value for money, emotional engagement, and an expectation that it will be provided with every interaction. In an environment where customers are more aware than ever about the standard of service they should receive, companies cannot afford to lessen their focus on customer service. Jo Causon, chief executive of the Institute of Customer Service, expressed this very clearly:

'Today's customers are savvy, discerning and expect organisations to relate to them as individuals, not as transactions. Customers have greater choice and access to an ever-expanding set of communication channels to express their preferences or displeasure.'

'...transparency, ease of doing business and the ability to manage problems are especially important for customers. Increasingly, organisations' success will depend on the quality of their relationships across the value chain – with customers, suppliers and employees.'

As an industry we can clearly do more as shown in the January 2014 UKSCI findings: *'Utility and transport operators dominate the lower reaches ... signalling the importance of keeping a clear focus on service.'*

Comprehensive engagement and understanding of customer future needs and expectations are of paramount importance to us. This underpins our Business Plan. It's in everyone's interest to commit to increasing customer satisfaction and it is clear that the SIM has improved customer satisfaction amongst the Industry.

Widely recognised is the view that by 2020 customer expectations and communication channels will be different to today. The future SIM therefore needs to consider and respond to this.

As long as the SIM continues to evolve, keeps pace with change and can be demonstrated to be fair, reliable and accurate our belief is that it will continue to be an effective measure of performance.

Consultation questions

The 8 consultation questions are shown below along with the Severn Trent response.

Questions on the overall design of the incentive

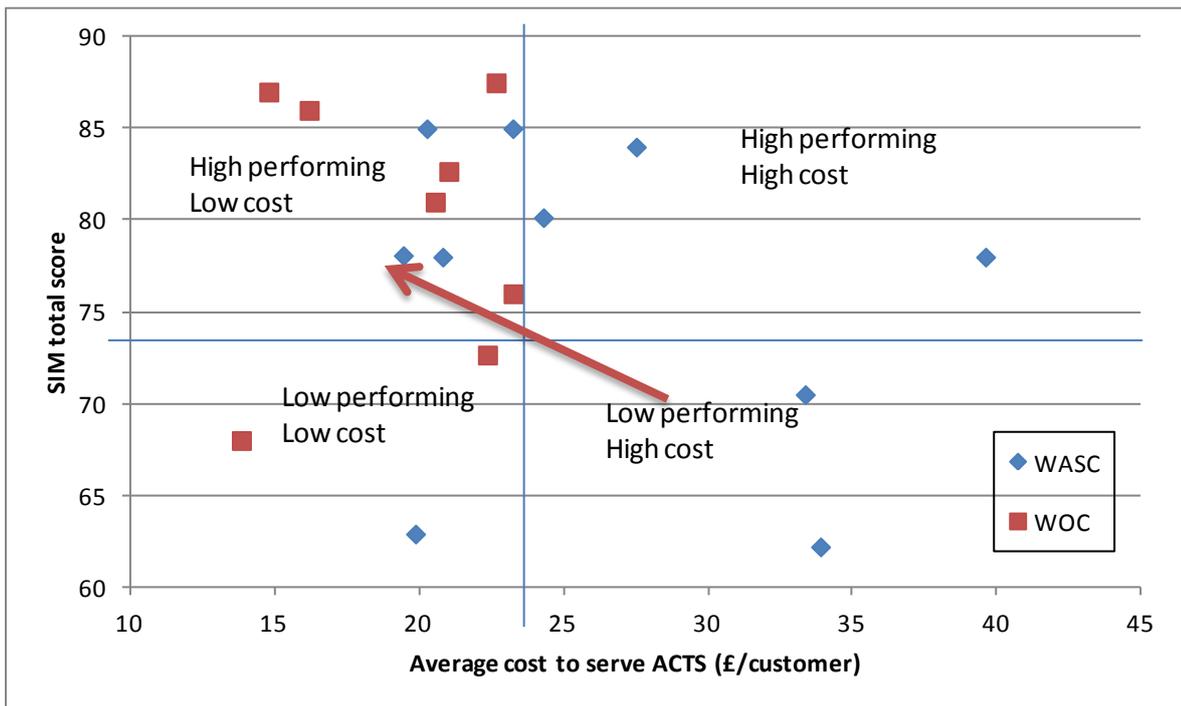
Q1 To inform the extent of the range for rewards and penalties, we invite views on:

- Our proposition that the SIM should continue to incentivise service improvements in companies operating below the frontier; and
- Whether, and if so in which areas, further service improvement by frontier companies should be incentivised – and the benefits of doing so.

Given the timing of this consultation, we would also consider evidence from any company outcomes beyond SIM.

We agree with the proposals. The service incentive mechanism should be used to drive both further improvements amongst those companies currently performing well and incentivise service improvement in below frontier operators. An area that we would be supportive of further exploration is considering SIM in the context of the cost to serve customers. Currently SIM incentivises companies to improve customer service, pushing forward a 'performance frontier'.

Plotting 'average cost to serve' against SIM score for different companies (see below) reveals that there are large variations in how efficiently customer service is delivered. There are separate incentives to reduce costs but it is unclear whether the balance between SIM and cost incentives is appropriate without an understanding of what the value is to customers of service improvements as measured by SIM. This is discussed further in our response to Q4



Q2 We consider that the SIM should continue to incentivise service quality throughout the value chain, and not just those elements under the sole control of retail businesses. The implication is that retail businesses would be exposed to the full financial risk of the SIM, which we expect to be passed on to wholesale businesses as appropriate.

We invite views on:

- the proposition that the SIM should continue to be used to incentivise service improvements throughout the value chain, rather than being focused entirely on ‘retail’ activities;
- how these incentives (and financial risks and rewards) might be passed through from retail to wholesale businesses; and the proposition that we should leave companies to develop internal ‘contracting’ arrangements as they see fit, rather than be subject to any prescribed arrangements.

We agree with the proposals outlined and that the focus has to be throughout the whole value chain. As SIM is focused on the domestic customers experience of service it is both wholesale and retail activities that count; the customers experience of these aspects is not distinct as far as they are concerned and the impacts of wholesale and retail activities on customer experience are not easily separated.

Questions regarding the detail of the design of the Service Incentive Mechanism

Q3 Design issue 1 – symmetric or asymmetric incentive?

The options we are consulting on are:

- **option 1** – retain current asymmetric structure;
- **option 2** – remove upside potential entirely (for example, no upside; retaining the downside of up to 1% of revenue); or
- **option 3** – move to a symmetric incentive (for example, upside and downside both up to 1% of revenue).

We believe that option 3, a symmetrical incentive, would be the best way forward as this would be the most likely way to encourage further dynamic efficiencies and innovation across both frontier and non-frontier companies.

We do not think option 2 is compatible with the direction that Ofwat is taking in its *risk and reward* guidance of 27 January. In the document and briefing that accompanied its release, Ofwat set out its aim to reduce the level of returns guaranteed through the return on capital, replacing it with returns that needed to be *earned* through performance.

The SIM incentive (and the OPA before it) is a long-standing element of the incentive framework. It would appear odd to withdraw it when Ofwat is encouraging companies to increase the value at risk for Outcome Delivery Incentives.

Reputational incentives are very powerful, but are made stronger if there is also financial incentive attached to them. It shows that Ofwat takes customer service seriously; it is one of the measures that external viewers look at when judging the quality of company management. Within companies, the potential reward for SIM (or avoiding a penalty) can also be used to justify expenditure for service improvement. As we set out above, there could be a trade-off between the cost of service and quality; if there is no financial benefit from quality, companies might be more likely to emphasise cost reduction.

Option 1 is only a marginal improvement over option 2. An asymmetric structure might be considered appropriate where companies are achieving very high levels of guaranteed returns and / or the consequences of service failure are very high. We do not think that the latter applies now and the level of guaranteed returns is set to reduce in future.

Q4 Design issue 2 – magnitude of financial incentive

Our current preference is to broadly maintain the current magnitude of financial exposure under the SIM in the range of +0.5% to -1.0% of total appointee revenue. (Dependent on responses to questions 1 and 2.)

Do you agree with this approach?

As noted in Question 3, we suggest a symmetrical incentive, and +/-1% could be appropriate. However, as with other Outcome Delivery Incentives, we consider that the magnitude of incentives should be based on the value of service improvement or deterioration to customers. Customer research for PR14 could contribute to making this assessment of the value to customers of service changes as measured by SIM.

Q5 Design issue 3 – balance of qualitative and quantitative measures

The options we are consulting on are:

- **option 1** – retain the current 50/50 weighting;
- **option 2** – shift the balance more towards qualitative measures (for example, 75% qualitative/25% quantitative);
- **option 3** – remove the quantitative measures entirely;
- **option 4** – shift the balance more towards quantitative measures (for example, 25% qualitative/75% quantitative); or
- **option 5** – remove the qualitative measures entirely.

Our view is that option 1, retaining the current 50/50 weighting is the most appropriate approach for two reasons:

Firstly, we believe that enhanced customer service is vital. However, of equal importance is the actual service delivery. For example, reducing the significance of the quantitative aspect may create a situation in which poor operational delivery results in increased complaints which are dealt with very well; whereas a more desirable situation would be for those complaints to never have arisen in the first place.

Secondly, the performance of companies has a much higher degree of variation in terms of the quantitative SIM score compared to the qualitative score:

| | Company | SIM (2012-2013) | | |
|------|----------------------|-----------------|------|-------|
| | | Quant | Qual | Total |
| WOC | Portsmouth | 23 | 45 | 68 |
| | Bournemouth | 43 | 44 | 87 |
| | Bristol | 42 | 44 | 86 |
| | Sutton & East Surrey | 39 | 42 | 81 |
| | Affinity | 39 | 43 | 83 |
| | South East | 30 | 43 | 73 |
| | South Staffs | 42 | 45 | 88 |
| | Dee Valley | 32 | 44 | 76 |
| WaSC | Severn Trent | 36 | 42 | 78 |
| | Thames | 27 | 36 | 63 |
| | Wessex | 41 | 44 | 85 |
| | Yorkshire | 35 | 43 | 78 |
| | Anglian | 39 | 46 | 85 |
| | Northumbrian | 37 | 43 | 80 |
| | Welsh | 39 | 45 | 84 |
| | South West | 32 | 39 | 71 |
| | Southern | 22 | 40 | 62 |
| | United Utilities | 35 | 43 | 78 |
| | Standard Deviation | 6.4 | 2.5 | 7.9 |

The standard deviation across all these companies is overall 7.9, whereas it is only 2.5 when considering the qualitative element alone. Therefore shifting to a system that takes greater account of the qualitative aspect is likely to make the league tables and comparisons less reflective of actual overall service performance.

Reducing the range of performance would not fit with Ofwat's aim, in the *risk and reward* guidance, of increasing the value of returns that need to be earned through service delivery. It would make the SIM a less powerful incentive and potentially reduce the effort that companies put into delivering

service improvement. Consequently, we recommend that the balance of 50/50 qual/quant is retained.

Any change to this balance should only be made if the assessment of value to customers suggested in the response to Q5 demonstrates that this is justified.

Q6 Design issue 4 – detailed design of the qualitative and quantitative measures

Please provide your views on the various options presented in detail in section 4.4.

| Option 0 (current SIM) | Option 1 | Option 2 | Option 3 |
|--|--|--|--|
| All lines busy and calls abandoned | Retain (pro rata where lines for household and non-household shared) | Remove | Remove |
| Unwanted phone contacts | Retain | Retain and add unwanted contacts from all media types | Remove – replace with complaints from all media types |
| Written complaints | Retain | Retain | Retain |
| Escalated written complaints | Retain | Retain | Remove |
| CCWater investigated complaints | Retain | Retain | Remove |
| Survey of satisfaction with handling of recent transaction (or series of transactions) all media types – resolved contacts | Retain for households | Retain, streamline to remove transactional questions, retaining key satisfaction and experience driver questions Retain resolved contact No notice period for survey | Replace with survey of consumers' perceptions and views of water company (sample contactees – but at any stage of transaction) |

There is no question that customers are anticipating multi-channel interactions and expect to engage using the communication method of their choice. We agree that providing this freedom and channel diversity is important, therefore we are supportive that the evolution of SIM as proposed by Ofwat, both recognises and strives to account for the voice of all consumers.

For each specific aspect here is our response:

All lines busy and calls abandoned.

Ease of contact is a critical requirement and one we are fundamentally committed to providing all of our customers, all of the time. We would support the removal of phone availability metrics purely on the basis that evidence suggests this is not a comparable metric for SIM due to the myriad of telephony systems in place across the industry. Our internal performance monitoring of telephone availability and service levels will continue.

Unwanted phone contacts

In principle we agree with option 2 in which contacts are from additional media sources. However, we have a concern that the scope and definition of 'media types' and 'unwanted contacts' is made much clearer. For example, we do not think it is appropriate to include all social media or editorial comment in newspapers as this is not necessarily indicative of the performance of the provider; it may reflect more broad issues of views on the industry as a whole. Fundamentally, we would like to see clarity about what is 'contact' as opposed to 'comment'. Furthermore, it is perhaps difficult to identify the author or origin of such an unwanted contact in the context of some media types; they may for example not even be customers. These concerns would apply to option 3. In addition, we need to be mindful of the logistical and resource implications that needing to identify and categorise a potentially diverse range of possible 'contacts' may impose upon companies. Some customers may also use multiple contact channels and this again may present difficulties in identifying and categorising this sub group.

Where companies make a point of opening up a communication channel and 'advertise' this for the purpose of registering a complaint we do consider this to be applicable for consideration within SIM. Beyond that definition we would consider engagement and assistance provided through, for example, social media to be outside the scope of SIM.

Written complaints

We agree with the proposal to retain this well established measure.

In addition, we believe it is now appropriate to review the weighting applied to E-Mail written complaints. We have seen a proportionate rise in E-Mail 'written' complaints as the use of smart phones becomes ever more popular. Over 60% of our written complaints are now received by E-Mail with customers instantly contacting and subsequently responding through this channel; a conversation through the customers preferred channel. The nature of this type of engagement is low effort and these interactions are more akin to a web chat or phone conversation, rather than the formal 'written' complaint this metric was originally intended to capture. If the significant weighing continues to be applied to E-Mail there is a concern companies may feel penalised for making it easy for customers (a disincentive in terms of providing ease of access through their customers channel of choice).

Escalated written complaints

We agree with the proposal to retain this measure.

CCWater investigated complaints

We agree with the proposal to retain this measure.

Consumer Focus research supports our own insight in that the following experiential aspects are of paramount importance to customers; individual concerns truly listened to, companies clearly taking ownership, feeling treated as a valued customer, a swift resolution, being kept informed of progress. However in the small number of instances where companies are unable to meet customer expectations and/or reach an agreed outcome it is critical that customers know there is somewhere independent and impartial they can turn to for support. Accepting this is extra hassle and therefore not ideal from a customers perspective it is reasonable to expect an increased penalty weighting.

Survey of satisfaction with handling of recent transactions

Overall our view is that the qualitative aspect of SIM needs to be fair, accurate and capture the voice of as many customers as possible. We would welcome an increase in the sample size surveyed per provider to enable greater statistical confidence when comparisons are drawn between companies, provided that the costs associated with such increases was proportionate.

The UKWIR testing confirmed that a streamlined survey could still deliver the required comparative data and customer insight without reducing the ability for customers to freely express their views. It appeared that sufficient detail remained to enable precisely what aspects of the customers 'journey' went well or otherwise, so as not to focus purely on determining overall satisfaction in isolation. Maybe this efficiency could facilitate an increase in customers surveyed during the forthcoming AMP. All customer feedback is extremely valuable, helping us to respond to customers needs and drive further service improvements, especially verbatim comment that we would want to see retained.

A Rawson, Duncan and Jones paper (Harvard Business Review, September 2013) suggests that the most important aspect of customer satisfaction is the customers end to end journey. The narrow focus on maximising satisfaction at individual touch points (prior to resolution) can create a distorted picture, suggesting that customers are happier with the company than they actually are. This aligns to our company research and 'Voice Of the Customer' insight. However, we do recognise that moving to the UKWIR suggestion of 'all contacts - at any stage of transaction' is likely to mitigate differing interpretations of 'resolution' that will aid in the comparability of the SIM qualitative scores; especially pertinent if a relative performance mechanism is retained. In this context we support the proposal of a limited notice period for such surveys to take place.

Social Media

In terms of extending various metrics in SIM to include new channels our views have been expressed above. However, some concerns are worthy of specific note and require further thought:

- the difficulty for providers to sufficiently resource the task of identifying and collating all of the other possible media contacts should their scope be too broad (e.g. general comments in social media or the news media)
- to be in a position to record an unwanted contact or a complaint, companies need to be able to identify the comment as coming from one of their customers. Many people use social media to voice opinion and don't actually expect/want companies to act upon their tweet
- clarity on what constitutes a complaint in the social media space as the language used is very different
- how to ensure that companies are not penalised for choosing to proactively engage with customers through social media or feel pressured to avoid this channel for fear of penalty - this appeared to be a suggestion expressed by an attendee at the Ofwat workshop - "if a company treats a comment as being a complaint then it is one".

Defined 'social media' guidance, with minimal scope for interpretation, is therefore critical.

Household customers

We agree that this is important for household customers only to be included in the qualitative SIM surveys.

Q7 Design issue 5 – use of absolute or relative performance

We invite views on:

- **option 1** – retaining the current relative incentive structure; or
- **option 2** – using absolute performance levels to set rewards and penalties (with suggestions of how we might set these).

In the context of the *risk and reward* statement, we think that targets based on absolute levels of performance should be considered. Ofwat's aim appears to replace returns guaranteed through the return on capital with rewards that need to be earned through performance. An absolute target gives the possibility that the SIM could have a net positive effect on company returns. A relative measure – even if symmetrical - will only redistribute potential earnings between companies.

Impact of relative measure



* Severn Trent's business plan proposal

A fixed target would not mean asking customers to pay more for the same service. The overall cut in the return means that they will be paying less. Companies would have to improve to get the same (or, given the strength of the incentive, marginally less than before).

With absolute targets there could still be penalties for poor performance. A fixed target would simply make it *possible* for all companies to achieve a reward. This would make delivering better service a realistic way of making up for the loss of guaranteed income, whereas a relative assessment can only ever produce a neutral result overall. For staff within companies a fixed target would be easier to understand than a moving one; and inter-company comparisons could still be captured (the reputational impact of doing worse than peer companies would remain).

Targets could be based on the mean performance from scoring SIM waves - or, if changes to the measurement of SIM make this too difficult, early waves from AMP6 could set benchmarks, and later ones would determine rewards and penalties. At successive reviews, if the incentive continues to be successful in motivating companies, one would expect that average to increase.

An asymmetric incentive based on relative performance does not appear compatible with this new approach. It simply exposes companies to greater risk at the same time as the WACC (which is supposed to cover business risk) is being reduced.

We support the notion that the scale of incentives and penalties are reflective of customers valuation of service impacts. This should help to decide whether frontier companies would continue to be rewarded for further improvement, and the split of rewards between quantitative and qualitative elements.

Q8 Design issue 6 – non-household SIM design for Wales

We are seeking views on two options for the incentive comparator for the Welsh company non-household SIM:

- **option 1** – to compare the non-household SIM score against the household SIM scores for England and Wales; or
- **option 2** – to compare the non-household SIM score against an absolute threshold level.

We invite comments on any additions or modifications that would be appropriate to the household SIM methodology for its use for non-households, including dealing with sample size issues from smaller customer bases.

We favour option 1 in which comparison is made with household SIM scores in England and Wales.

In terms of any additions or modifications to the household SIM methodology we feel it is important to ensure that the sample of customers used to determine SIM performance is robust and representative and that sanctions should be imposed if companies attempt to distort the result.