

Service incentive mechanism (SIM) for 2015 onwards

Southern Water's Response



Southern Water's response to Ofwat's consultation on the service incentive mechanism (SIM) for 2015 onwards

Introduction

We are pleased to provide you with our response to your consultation on the design of the SIM.

The SIM has driven significant improvements in the quality of customer service, including amongst the lowest-scoring companies. We support its continuation, and agree that it is now appropriate to review its design to ensure it remains effective.

In summary, our view is that the SIM should:

- incentivise companies to deliver further customer service improvements;
- incentivise wholesale as well as retail activities;
- have symmetric penalty and rewards in line with Ofwat's recent guidance on risk and reward;
- increase the magnitude of the existing financial reward;
- an exclusively qualitative measure, with a widened scope including the views of the generality of customers;
- be based on absolute performance.

If quantitative measures are to be retained, greater standardisation is required to ensure company comparison is more robust;

We develop these points below, and follow this with our responses to the specific consultation questions.

General comments

1. Incentives

We believe that the SIM should incentivise companies to deliver further service improvements for their customers.

The customer engagement we undertook to inform our 2015 to 2020 business plan has shown that customer service expectations are increasing, and are set by reference to companies operating outside the utility sector. Whilst customers expect a reliable service, they have limited interest in redress other than for high impact events. Most significantly, we found that customer expectations are broader than just receiving responsive customer service. They now include the expectation that we will strive to make their bills affordable, and provide them with better information so that they can make more informed decisions about how they use our services.

We therefore believe that companies should be incentivised to deliver further service improvements, and that this should be facilitated by the inclusion of a broader measure of customer satisfaction than simply contact quality. We discuss this in more detail below in section 4.

2. Sharing of financial risk

We support the SIM being focussed on wholesale as well as retail activities. This is in recognition of the fact that the delivery of high quality customer service will ultimately be reliant on the performance of the wholesale business.

We support companies deciding on how the incentive/penalty should be shared between their wholesale and retail businesses.

3. Symmetry and magnitude

We believe that the SIM should be symmetric, increasing the magnitude of the existing financial reward.

We believe that this is more consistent with Ofwat's recent risk and reward guidance, which made clear that *"An effective package of rewards and penalties will benefit customers by providing meaningful incentives to encourage the best service. The most effective incentives link financial returns to company performance and consumer experience."*

4. Moving to a qualitative measure and widening of scope

As outlined in section 1 above, our research shows that the expectations of our customers are increasing, and are broader than just receiving responsive customer service.

Taking these findings into consideration, we support making the SIM a wholly qualitative measure, with a widening of its scope to include the views of customers who haven't had need to contact their water company.

This could be achieved via the introduction of a broader measure of customer satisfaction rather than just contact quality. Measures such as Net Promoter Score, customer perception of value-for-money or service effort could be considered in this context. This would reflect the position in competitive markets, facilitating benchmarking, and incentivise companies to look for ways to increase customer satisfaction as opposed to counting incidents of 'failure demand'.

The current design of the quantitative aspects of the SIM create challenges in connection with reporting accuracy. A SIM based on qualitative measures would remove the reliance on companies exercising judgement when recording performance.

5. Concerns regarding the retention of quantitative measures

Whilst our preference is for the removal of quantitative measures, if they are to be retained then we do not support the widening of customer contact to include new channels as this will lead to continued debate about definitions and application. It will also lead to an escalation in administrative overheads.

If quantitative measures are to be retained, the scope of the SIM should be limited to unwanted phone contact and written complaints. This would need to

be accompanied by greater effort to ensure standardisation of company reporting to ensure comparison is more robust; for example via an increase in the use of horizontal auditing. Our view is that some of the current differences in company performance under the SIM are explained by measurement rather than management.

We have concerns that complaints are the least standard measure within the SIM, and that their inclusion incentivises companies to try to avoid complaints at all costs rather than seeing them as an opportunity to get useful feedback from customers and improve service. Indeed, in this context we have taken steps to make it easier for our customers to complain. In competitive markets it is not uncommon for service improvements to be informed by customer feedback, with complaints seen as a valuable source of insight to drive improved customer satisfaction.

6. Using absolute performance

Finally, whilst we recognise that it may be more complicated, we support a move to the use of an absolute performance measure because it would make the SIM an even more effective incentive. The use of absolute performance would provide companies with a level of certainty over the likely benefits when making investment decisions which may increase their ACTS.

One option could be to develop the survey to facilitate comparison with other industries, and set targets on a rolling annual basis. For example, the year one survey could be used to set the absolute target for year two. If this were combined with annual incentive / penalty payments (rather than waiting until the AMP period has ended) then it would create a stronger link between company performance and consequence, and make it easier for companies to justify investment to improve service.

Response to specific consultation questions on the design of the SIM

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.

Please see section 1 of our General comments – We believe that the SIM should incentivise companies to deliver further services improvements

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.*

Please see section 2 of our General comments – We believe that the SIM should be focused on wholesale as well as retail activities, and companies should decide on how the incentive/penalty is shared.

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).*

Please see section 3 of our General comments - We support option 3, which aligns with Ofwat’s risk and reward guidance.

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?

Please see section 3 of our General comments and our response to Q3 - We support a symmetric incentive and increasing the magnitude of the existing financial reward.

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.*

Please see section 4 of our General comments - We believe that the SIM should be a qualitative measure, and the scope widened to include the views of the generality of customers.

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

As per Q5, please see section 4 of our General comments - We believe that the SIM should be a qualitative measure, and the scope widened to include the views of the generality of customers.

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).*

Please see section 6 of our General comments - We believe that the SIM should use an absolute measure of performance.