



Price Review Programme Team

Strategy & Regulation

Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Name Nick Fincham
Phone 0203 5774989
Fax 0118 3738918
E-Mail nick.fincham@thameswater.co.uk

31 January 2014

Dear Sheila

SERVICE INCENTIVE MECHANISM (SIM) FOR 2015 ONWARDS – A CONSULTATION

Thank you for the opportunity to respond to your consultation document 'Service Incentive Mechanism (SIM) for 2015 onwards – a consultation'.

We support the continued use of SIM in AMP6. SIM has worked well in driving improvements in customer service across the water sector during AMP5 and it is essential that the sector continues to improve to maintain legitimacy with customers. We recognise that we need to improve our customer service performance. We have begun to see improvement in our customer service performance and plan to improve it further as set out in our PR14 plans.

In many areas, the current design of SIM remains fit for purpose. We have suggested refinements to focus SIM on improving customer service (rather than wider goals covered by other incentives) and to address some of its current limitations.

We understand from the SIM workshop on 24 January 2014 that 2014-15 will be a pilot year for the new form of SIM. We strongly support this approach and would be keen to participate in forthcoming workshops to assist with defining the quantitative and qualitative measures. We would welcome an opportunity to work with Ofwat and the industry during 2014-15 to reflect on the pilot findings and support Ofwat in finalising SIM for AMP6.

We also understand that Ofwat has no plans to continue the existing CSAT survey in 2014-15. We would support the continuation of the CSAT surveys during 2014-15, until the new form of SIM is confirmed. This would allow companies to continue to measure performance on a consistent basis, track improvements over time and would provide reputational incentives in 2014-15.

We recognise the importance of a level playing field for all companies to retain strong incentive properties under a comparative measure and provide a proportionate level of robustness given the scale of the financial rewards and penalties. We appreciate that there is currently the potential for reporting inconsistencies that should be addressed, for example, differences between companies in the definition of a resolved contact. We would therefore support the use of horizontal audits during the test year (2014-15) and at set intervals thereafter (e.g. every two years) to provide Ofwat, customers and companies with assurance

that the changes to SIM for AMP6 put forward by Ofwat and the current UKWIR project align with the principle of a level playing field.

Our suggestions are consistent with Ofwat's framework (i.e. to be applied to household customers only in the Household Retail price control), our business plan and the government's principles for economic regulation.¹ In line with this, we would welcome clarity at an early stage around how SIM incentives will be calculated for AMP6.

In summary, we have suggested the following refinements of SIM for AMP6:

- SIM should be capable of applying to the Wholesale and Household Retail functions separately, though companies should be permitted to determine the arrangements between these business functions.
- SIM should have both quantitative and qualitative components, with refinements to and equal or greater weighting for the qualitative component. We would welcome the weighting options to be explored in more detail during the 2014-15 pilot year.
- The quantitative component should be refined by removing or replacing unnecessary measures, to focus on the service provided to customers and to improve comparability between companies.
- The qualitative component should be a rolling customer satisfaction survey taking place on a more frequent basis than now, to improve the accuracy of the measure and make it more dynamic in measuring performance.
- Rewards remain appropriate to drive further improvements in service and thus the current scale of the incentive seems broadly fit for purpose.
- We consider that incentives based on absolute performance have a number of features that could strengthen customer performance incentives across the industry. We have set out a practical process for how incentives based on absolute performance could be developed alongside incentives based on relative performance for AMP6, or for future reviews.

Please find responses to the consultation questions in the appendix to this letter.

Please do not hesitate to contact me or my team if you have any questions or comments on our response. We look forward to working closely with Ofwat in supporting the development of the final PR14 methodology.

Yours sincerely



Nick Fincham
Director of Strategy & Regulation

¹ For example, incentives should be transparent, consistent and targeted. (Source: Department for Business Innovation & Skills, "Principles for Economic Regulation", April 2011.)

Appendix 1 – Detailed responses

Overall design of the incentive

Key messages:

- Rewards remain appropriate to drive further improvements in service
- It is not clear that comparative SIM will be the best way to drive frontier improvements – methods that complement the Outcomes approach may be more effective
- SIM should apply across the whole value chain, with companies determining the arrangements between Wholesale and Retail

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 that SIM should continue to use rewards and penalties to incentivise service improvements in companies operating below the frontier. This will create strong financial and reputational incentives to be the best industry performer.

We consider that further service improvements by frontier companies should be encouraged, e.g. to take-up innovations that are best practice in other industries. An incentive based on comparative performance may not be the best tool to achieve this. We have seen evidence in a number of companies' plans of how the Outcomes-based approach has encouraged innovation in Retail beyond SIM. For example, we have specified outcome targets for new online account management for customers, increasing the number of customers on payment plans, increasing cash collection rates and introducing a social tariff. We discuss in our response to question 7 how SIM could be based on company-specific performance targets in future to build on the Outcomes-based approach to encourage innovation.

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.**

The Wholesale business has an important role in delivering improved levels of end-to-end customer service. The incentive should therefore apply to the whole value chain.

Companies will have different arrangements between their Wholesale and Retail elements. For example, as stated in our business plan, we plan to have distinct business units for Wholesale and Retail, with service level agreements to determine how SIM is shared. We have begun this work by specifying targets around SIM elements in Wholesale as well as Household Retail. We consider that this will drive improvements.

But this approach may not be right for other companies, which will be best placed to determine how best to incentivise customer service improvements given their company structure, management structure and AMP6 statement of commitments.

We consider that the general movement towards separation of companies’ Wholesale and Household Retail functions means that the greatest benefits to customers would be seen by setting incentives on the basis of absolute targets. As discussed in our response to question 7, we consider that absolute targets would create strong incentives for all companies to achieve the Outcomes that their customers want, while encouraging greater ownership of plans and innovation.

Detailed design questions

Key messages:

- We support retaining the current asymmetric structure
- We do not have a strong view on the appropriate magnitude of financial exposure, though there are reasons to maintain the current magnitude
- Moving to company-specific targets would be consistent with creating strong incentives for all companies to achieve the Outcomes that their customers want.
- We support the use of both the quantitative and qualitative components, with refinements. The weightings should follow these refinements.

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 see clear benefits from continuing to use rewards to drive companies to be the best industry performer and from using penalties to protect customers. Therefore we do not consider that option 2 is appropriate.

We have seen from the experience of SIM in AMP5 that incentives do not need to be symmetrical to drive improvements across the industry. We also note, though, that Ofwat's recent risk and reward guidance² sets out that companies should be looking at proposing more meaningful rewards in AMP6 to encourage the best service.

This suggests either option 1, with an asymmetric structure, or a more symmetric incentive under option 3, would be appropriate.

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?

We do not have a strong view on the appropriate scale of the incentive, though we support maintaining the current magnitude.

In our business plan, we have assumed the current magnitude of financial exposure under SIM within our overall modelling and assessment of the balance of risk and reward. We

² Ofwat, "Setting price controls for 2015-20 – risk and reward guidance", January 2014

consider that other companies are likely to have done the same, as Ofwat has previously communicated that it was minded to keep a similar level of financial exposure.²

This means that it seems reasonable to maintain the current scale of SIM, as this should be consistent with the balance of risk and rewards assumed in company plans.

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.**

The quantitative and qualitative components measure different aspects of customer service: success in reducing the number of complaints and escalations, and customer satisfaction respectively.

We consider that the appropriate weighting should follow the detailed design of SIM. As we discuss in response to question 6 below, we consider that both the quantitative and qualitative components can be improved by refining the quantitative component and increasing the scope of the qualitative component. There may therefore be a case for increasing the weighting of the qualitative component, which means that either option 1 or option 2 would be appropriate.

We would welcome the weighting options to be explored in more detail during the 2014-15 pilot year, and perhaps in the future the industry could focus on just one high level measure, for example a customer satisfaction survey.

We note that the refinements we have suggested would be necessary alongside any changes to weighting, to prevent any further convergence of companies' SIM scores thereby maintaining the effectiveness of an incentive based on comparative performance.

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.

The quantitative component currently captures both customer service failures and asset failures; however SIM is not the most effective incentive to improve performance against the latter. The Wholesale outcomes, targets and incentives that companies proposed in their business plans will focus on these, and therefore SIM should focus on improving customer service failures. This will provide better indications of how well the Retail business unit has performed in delivering customer service and how well the Wholesale business unit has performed in restoring service (with strong incentives on Retail to put pressure on Wholesale to restore service as quickly as possible to customers' expectations).

³ Ofwat, "Setting price controls for 2015-20 – final methodology and expectations for companies' business plans", July 2013, page 71.

We have therefore proposed the following refinements:

- Remove the unwanted calls measure. This is a complex measure to report and therefore removing it from the quantitative element would assist with resolving reporting inconsistencies. UKWIR are proposing replacing the measure with telephone complaints. We would support this approach if there is a clear and simple definition.
- Remove the abandoned calls and all lines busy measures. These are important internal measures, however we support Ofwat's preference to exclude these measures from SIM as the call experience is measured through the qualitative component and it may be difficult to separately measure performance for household customers only.
- Retain the written and escalated complaints measures. This is consistent with measuring the experience provided to customers for unresolved complaints.
- Introduce the Alternative Dispute Resolution (ADR) scheme.

We are not convinced that introducing other media types would improve the measure. It would increase complexity, making it more difficult to measure performance consistently between companies, and may disincentivise companies from introducing new, innovative ways of communicating with their customers.

Though not part of the consultation, we would support a review of the denominator used to normalise the quantitative contact measures (currently 1,000 connected properties) during the 2014-15 test year. For example, the retail average cost to serve in AMP6 will be normalised according to the number of unique customers (with a 1.3 multiple for customers served by both water and wastewater services), recognising the greater cost (partially offset by economies of scope) from serving customers with two services rather than one. We note that aligning SIM with this retail cost approach would bring average scores for WaSCs and WOCs more in line,⁴ and may lead to a more representative picture of relative performance.

For the qualitative component, we consider that the detailed design changes for Option 2 or Option 3 do not address all the current issues with the current measure. We have identified the following potential improvements:

- The survey could be carried out on a more continuous and frequent basis (e.g. sampling a percentage of customers who had a resolution each day). This would:
 - improve the accuracy of the measure – service performance would be measured on a more regular basis, sample size could be increased and the effects of unusual events would be reduced;
 - lead to timescales between customer contact and survey that are more similar between larger and smaller companies, making them more comparable; and
 - provide more dynamic feedback on levels of performance – this strengthens the incentives to deal with problems more quickly to restore service.
- We would support the piloting of a customer effort question in the customer satisfaction survey, which is being explored as part of the UKWIR project. We will need to work carefully through the outcome of the pilot before any amendments are implemented.
- We would also support adding a measure based on providing 'value for money' to all customers in evaluating an overall score. Consistent with the approach to Outcomes and greater customer engagement, companies are likely to vary in their service offerings to customers (e.g. with different trade-offs of levels of customer service and

⁴ For example, this change to the denominator means that the two year average (2011-13) SIM score for WaSCs moves from 74.5 to 77.5, much closer to the WOC average score of 77.2. Similarly, the average rank for a WaSC improves from 11th to 10th as a result of the change, equal to the average rank for a WOC (which falls from 8th to 10th as a result of the change).

cost). Adding a 'value for money' measure would help measure whether companies are getting this balance right.

- Company scores are converging, as shown in Ofwat's consultation (figure 4). This means that setting financial incentives on the basis of standard deviations in industry data may lead to material differences in financial rewards/penalties from non-material differences in scores. It is therefore important to ensure that data used is statistically robust to provide a level playing field, and that the distribution of rewards and penalties are set so that companies improving their performance are able to incur lower penalties or higher rewards as a result, leading to meaningful incentives to improve (which may not be the case if the distribution of rewards/penalties are only based on numbers of standard deviations, and hence other companies' performance).

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).**

While a SIM incentive based on relative performance might be the most practical option, we consider that moving to company-specific targets, with incentives set against those targets, would be consistent with creating strong incentives for all companies to achieve the Outcomes that their customers want.

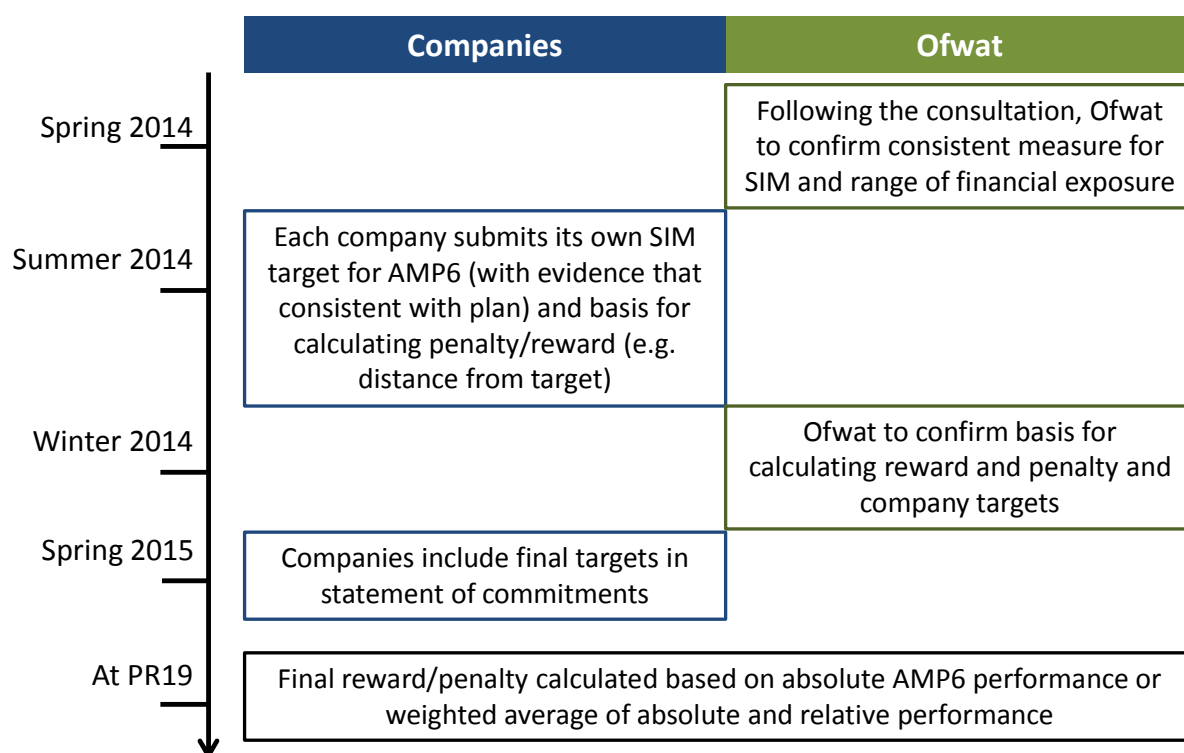
This would reflect differences in customers' priorities, by setting targets based on what is required for specific companies' customer bases. It also addresses any differences in companies' operating circumstances or reporting methodologies that affect targets.

This would be desirable as it would reflect differences in customers' priorities in setting targets, meaning that even companies at the top of the table could have stretching targets if their customers are seeking significant further improvements to service. It would also take account of any differences in companies' operating circumstances or reporting methodologies that affect targets, leading to more transparent and effective incentives.

To ensure customers are protected when implementing this change, we would suggest that the financial reward or penalty be based, at least initially, on a mix (e.g. weighted average) of relative and absolute performance. This would retain incentives for both catch-up improvements and improvements in the frontier.

We illustrate in Figure 1 below how this could work in practice for PR14. If Ofwat concludes that it is not practicable to attach financial rewards and penalties against absolute performance in AMP6, then an alternative approach might be to pilot the setting of absolute performance targets during the test year (2014-15) or during AMP6, with the aim of attaching financial rewards and penalties at subsequent price reviews (i.e. similar to the approach followed for the abstraction incentive mechanism).

Figure 1 – Option for basing SIM on absolute performance



Source: Thames Water

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 have no comments on the options for the Welsh company non-household SIM.