

The logo for Which? is a red square with the word "Which?" in white, bold, sans-serif font. The question mark is slightly larger and more prominent than the word.

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Date: 04 February, 2014 Response by: Simon Osborn

## Consultation Response

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### Service incentive mechanism (SIM) for 2015 onwards

#### About Which?

Which? is the largest consumer organisation in Europe. It is an independent, not-for-profit consumer organisation with almost 800,000 members. Which? is independent of Government and industry, and is funded through the sale of Which? consumer magazines, services and books. Which?'s mission is to make individuals as powerful as the organisations they have to deal with in their daily lives by empowering them to make informed decisions and by campaigning to make people's lives fairer, simpler and safer.

#### Summary of our response

- As the Chairman of Ofwat has recognised, water customers are having a tough time. There has been a 7% real increase in water bills since 2005, and 35% in nominal terms. Bills have increased by over 12.5% since 2010 (in nominal terms) while households have seen their incomes decline over the same period, by as much as 5% for some households<sup>1</sup>. Which? research shows that many households are continuing to feel the financial squeeze: in the month of December 2013, 31% of consumers said they had cut back on essential spending. This is the context in which the SIM is being introduced. Even a small reduction in household bills is to be welcomed and a small increase needs to be fully justified.
- In this market where household customers cannot switch supplier, the introduction of the Service Incentive Mechanism (SIM) to drive good levels of customer service is welcome. It is beneficial to align company incentives with customer outcomes. However we recommend a number of changes are made to the structure of the SIM and to the underlying parameters. We believe this will improve the effectiveness of the mechanism, while reducing the potential cost burden of it on consumers.

<sup>1</sup> *Observations on the regulation of the water sector*, A lecture by Jonson Cox, Chairman of the Water Services Regulation Authority (Ofwat), Royal Academy of Engineering, 5 March 2013.

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- First, the SIM should focus on incentivising service improvements for poorly-performing companies. If an upside is to remain, Ofwat would need to demonstrate first, that one or more companies is delivering truly exceptional service and, second, that the benefits of this approach exceed the costs. Companies should not receive a financial reward for simply providing a decent level of service, such as for answering the phone, when customers should expect this from any service provider even if they operate within a non-competitive, price regulated monopoly. The design of the SIM must ensure that it incentivises companies to strive for excellence.
- Second, to strengthen the SIM, the penalty element should be increased from -1% to -3%. And to ensure that the penalty is a real incentive to the poorest-performing companies, and does not just exist on paper, the maximum penalty should be applied to them - unlike Ofwat's illustrative approach set out in 2013 (see Question 3) which could be interpreted as implying that the maximum penalty would not be applied to any companies. This would provide a strong incentive on suppliers to improve their service standards and result in a welcome reduction in customers' bills.
- Third, Which? recommends that an absolute rather than a relative incentive be applied. An absolute incentive has the benefit that poor-performing companies receive a penalty if their level of service is 'poor', no matter what the performance of their peers. This may not be possible before the current price review is finalised, but adequate household data should be available to enable Ofwat to define a 'target' level of customer service, which would set the bar sufficiently high to be stretching. In the meantime - assuming an absolute incentive is not feasible immediately, the full penalty should be applied to the poorest-performing companies. The customer service standard/bar should be reviewed and reset every two to three years as performance improves to ensure continuous improvement.
- Fourth, in the short term, a number of immediate changes need to be to the SIM before the introduction of PR14:
  - Greater weighting should be placed on the customer satisfaction survey, with less on the customer handling metrics, because the SIM is aimed at helping meeting customers' expectations.
  - Complaint handling should be given more emphasis in the customer survey, with less on contacts that are categorised as a 'transactional' nature, such as queries around bills, rather than complaints. Customer satisfaction with the rate of resolution of complaints should also be measured.
  - The quantitative element should include the time taken to resolve complaints to incentivise providers to deal with them speedily.
  - The notice period given to call centres before the survey should be removed.
  - Inconsistencies and weaknesses in reporting that have been identified should be addressed.
- Finally, in the longer term, more substantial reform to the SIM is required. Even with the changes above, the quality of the SIM is limited because it measures service only with customers who contact their supplier (12% of customers on average). To ensure that the SIM better reflects the experience of all customers of water providers, a broader incentive based on general customer satisfaction through a survey of a representative sample of all customers, not just customers who have contacted the company, should be introduced.



The survey could include issues such as clarity and accuracy of bills and ease of access to information. Some of this data is already included in the Consumer Council for Water (CCW)'s annual household tracking surveys. Potentially, this could be combined with a score for an assessment of any customer services incentives in place within the company for staff and/or senior management.

- Outside the SIM, the immediate priority is for Ofwat to ensure that companies' business plans in the current pricing review include robust value for money and affordability commitments. This is essential because CCW's annual tracking survey has found that the biggest issues for domestic customers are value for money and affordability<sup>2</sup>. The SIM does not incentivise value for money improvements in this area, and nor would it be appropriate to reward companies financially for charging customers less. The price review is the appropriate mechanism to do this and Ofwat has an essential scrutiny and challenge role here. The new business plans must ensure address value for money and affordability in the best interests of consumers and provide full explanation to consumers that the new bills will be as low as they can be.

**Question 1: 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' (i.e. the best performing companies in the sector); 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.**

Which? considers that the SIM has a valuable role to play in aligning company incentives with customer service outcomes. There have been significant improvements in the customer service outcomes included in the SIM in recent years. The extent to which the SIM has influenced these improvements does not appear to have been assessed - other factors may also be at play. But complaints to water companies have fallen for four years in a row, the number of complaints escalated to the Consumer Council for Water (CCW) has fallen significantly and consumers are increasingly satisfied with the manner in which their water company resolves their queries<sup>3</sup>.

Yet the consultation points out that there has been greater improvement in scores at the lower end (below average), i.e. the SIM has been more successful at promoting 'catch up' efficiency from poor performers than in encouraging best practice and innovation among the best-performing companies. It recognises that the justification for the SIM continuing to incentivise outperformance is less clear. Which? therefore recommends that the priority is to ensure that the SIM is structured as a penalty which applies to most, but not all, of the companies.

Which? does not consider it appropriate for any company to be financially rewarded at the direct expense of customers for providing a decent or even good level of customer service unless such

<sup>2</sup> Annual Tracker Survey 2012, Report by Accent for Consumer Council for Water, June 2013.

<sup>3</sup> Ofwat SIM survey: 2012/13 Annual report, McCallum Layton for Ofwat.



reward can be fully justified (see our response to Question 3). Yet under the proposals, companies would be rewarded for simply providing a decent level of service, such as answering the phone more promptly than the average in the sector, rather than for exceptional service.

By setting stretching customer service targets, Which? considers that the SIM should be an effective tool to drive up the level of customer service performance of all companies. The SIM should be particularly useful at improving the quality of service provided by the poorest performing companies but can also be used to incentivise the top performers. This can be done through ensuring that the maximum penalty is applied to the poorest performers and that only the top performers are exempt from penalty, or receive a small reward if that can be fully justified (see too our response to Question 3).

***Question 2: 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.***

Which? recognises that separate price controls for retail and wholesale are to be introduced in the new price review and that, because of the new way in which the price controls will be set, that the SIM needs to be applied to the retail price control only. It is important, however, that the SIM should continue to incentivise service quality throughout the value chain - i.e. wholesale and retail - given that many of the complaints raised by consumers relate to wholesale service delivery, such as blocked sewers and drains and water supply interruptions. From the consumer perspective, the distinction between wholesale and retail is academic.

We do not believe that the proposals based on internal contract arrangements between the wholesale and retail business units are sufficient and consider that it is risky to place such reliance on them. We are concerned that the incentive on the wholesale business will be lost because it is not the part of the business that the customer contacts. Therefore there needs to continue to be a form of mechanism whereby the wholesale business is incentivised directly, as that will often be the part of the business that needs to improve its service.

***Question 3: 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).*

As stated above (our response to Question 1), Which? does not agree that the SIM should retain an upside (reward element) unless this can be fully justified. On the basis of the evidence provided, Which? currently supports Option 2 as we are not yet convinced that the case has been made that any company has delivered such exceptional service performance to justify a reward. Option 2 would continue to provide an incentive for companies to perform better than average while providing a strong incentive for poorer-performing companies to up their game.

It would be particularly inappropriate to permit the companies a financial reward without insufficient justification when so many households are continuing to feel the financial squeeze. Our latest research found that, in the month of December 2013, 31% of consumers said they had cut back on essential spending and 36% of households had cut back their spending on essential items or used an authorised overdraft, payday loan, or defaulted on a loan or housing costs<sup>4</sup>. The Chairman of Ofwat has also recognised that water customers are having a tough time. There has been a 7% real increase in water bills since 2005, and 35% in nominal terms. Bills have increased by over 12.5% since 2010 (in nominal terms) while households have seen their incomes decline over the same period, by as much as 5% for some households<sup>5</sup>. There has been an increasing level of criticism in the media and in parliament around high levels of water company returns. This provides even more reason why water companies and the regulator need to make the case that a reward element is deserved.

We do not consider it appropriate to financially reward companies at the direct expense of consumers, so increasing the financial squeeze on households, for providing a reasonable level of customer service as that should be the minimum expected of any sector. For an upside to remain, Ofwat would need to demonstrate first, that one or more companies is delivering truly exceptional service and, second, that the benefits of this approach exceed the costs - including the costs to consumers in the form of higher prices through the price review.

Furthermore, even without a financial reward, companies would receive operational and reputational efficiencies from improving the quality of service.

*The worst performing companies should be penalised fully; high performers should receive no penalty and only the very best companies should be eligible for any reward - but any reward needs to be justified fully*

Which? also recommends that Option 2 be amended so that, as well as removing the upside potential if that cannot be justified, that the sliding scale applied to correlate the SIM score with the SIM reward/penalty should also be amended. Ofwat's *illustrative* approach set out in the Price Review 2014 (PR14 methodology) was to apply rewards and penalties on a straight sliding scale, with the maximum 0.5% reward being applicable at 'x' standard deviation(s) above industry

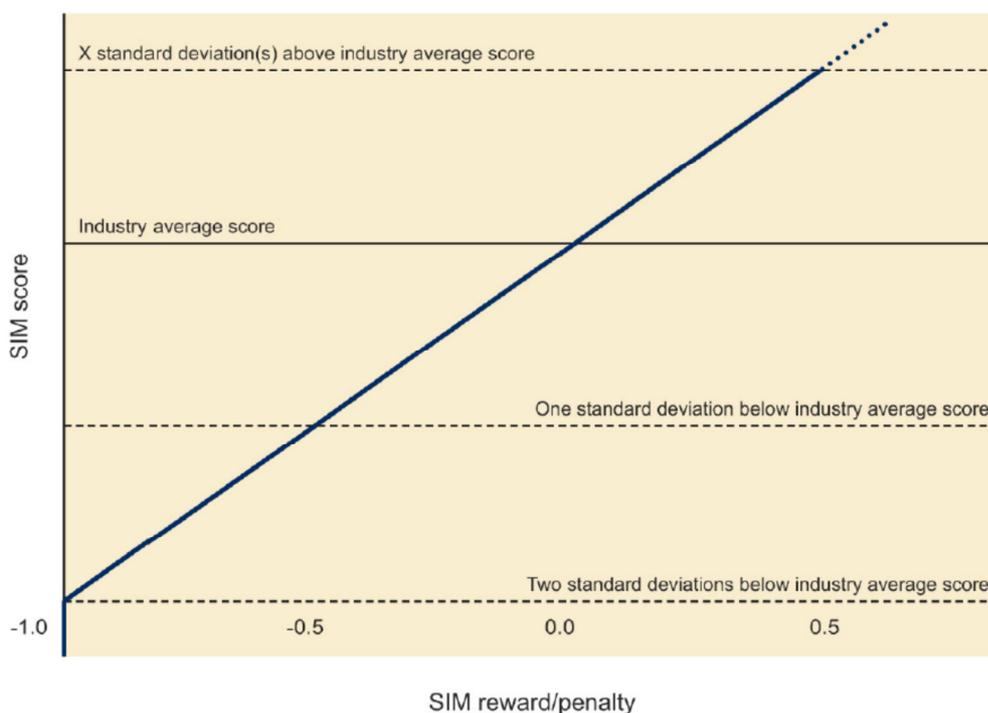
<sup>4</sup> Which? Consumer Insight Tracker, December 2013. See <http://consumerinsight.which.co.uk/>

<sup>5</sup> *Observations on the regulation of the water sector*, A lecture by Jonson Cox, Chairman of the Water Services Regulation Authority (Ofwat), Royal Academy of Engineering, 5 March 2013.



average score and with the maximum -1.0% penalty being applicable at two standard deviations below (Figure 1 below)<sup>6</sup>.

**Figure 1: Ofwat's illustrative approach to setting SIM rewards and penalties for 2010-15 (based on 2011-12 data)**



We accept that this approach is purely illustrative but no companies, on the basis of current scores, would receive the maximum penalty level of -1.0% (Table 1 below)<sup>7</sup>. Yet, if 'x' is defined as one standard deviation, four companies would receive the maximum reward. Ofwat has not indicated what approach it will take, i.e. what 'x' will be, but defining 'x' as one standard deviation would be overly generous towards the companies.

<sup>6</sup> Setting price controls for 2015-20 - final methodology and expectations for companies' business plans, pages 152-153, Ofwat, July 2013.

<sup>7</sup> Ofwat Information Notice IN13/11, 2013. The standard deviation is 8. The industry average score is 76, and the lowest score is 63, above the score of 60 which is two deviations below. This is on the basis of companies two-year average SIM score over 2011-2013.



**Table 1: SIM scores 2011-13, Ofwat**

Company	Two-year average SIM score	Comparison to industry average
South Staffs Cambridge	86	More than one standard deviation above the industry average
Sembcorp Bournemouth	86	
Bristol	85	
Wessex	85	
Anglian	82	Between the industry average and one standard deviation above
Dŵr Cymru	81	
Affinity	79	
Northumbrian	79	
Sutton and East Surrey	79	
Yorkshire	77	
Industry average	76	(standard deviation = 8)
Severn Trent	74	Between the industry average and one standard deviation below
Dee Valley	73	
United Utilities	73	
South West	69	
Portsmouth	66	More than one standard deviation below the industry average
South East	64	
Southern	64	
Thames	63	

Which? therefore suggests that the line be shifted ‘upwards’ so that the maximum penalty be applied to the poorest-performing companies. The threshold for the maximum penalty should be companies with a SIM score more than one standard deviation below the industry average. High performers, i.e. companies more than one standard deviation above the industry average, would not receive a penalty. The very best companies would be eligible for a reward if the case for a reward has been justified. The full reward should therefore only be given to companies at least two standard deviations above the industry average. This ensures there is an incentive to strive for excellence. To give the full reward to all companies more than one standard deviation above the industry average would be over-generous and insufficiently stretching.

In the longer term, we also recommend moving to an absolute scale (see our response to Question 7). Building on existing household data, Ofwat should start to put in place whatever additional data collection is needed to enable it to define a ‘target’ level of customer service, setting the bar sufficiently high to be stretching. And all companies who fail to hit the target penalised on a sliding scale. Only the very best performers should, potentially, be eligible for any reward. To ensure continuous improvement, the bar should be reset every two to three years as performance improves.

#### **Question 4: 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?***

Which? has explained above (see our response to Question 3) that companies with better-than-average service should not be financially rewarded through being allowed by the regulator to



charge higher bills unless this can be fully justified. If such justification cannot be provided, Which? recommends that +0.5% be reduced to 0%.

We also recommend that the penalty element be increased from the proposed -1% to -3%. This would not only be a stronger driver to invest in service improvements. It would also provide a welcome, albeit limited, reduction in bills for some customers whose providers fail. For example, 3% of the turnover of Thames Water, the company with the highest turnover in 2012-13, i.e. £1,759 million, is £52.8 million<sup>8</sup>. Assuming, for illustrative and hypothetical purposes only, that Thames Water was required to pay the full 3%, that would equate to a bill reduction of around £3.50 when applied across the Thames customer base of around 15 million customers.

A higher level of penalty would also be in line with what CCW has advocated for some time. In 2009, before the introduction of the SIM, CCW stated that -3% would be more reflective of the penalty for a poorly-performing company in a competitive market. CCW has pointed out that 4% of household customers wanted to switch supplier because of dissatisfaction with their service provider<sup>9</sup>. We agree too that Ofwat's -1% falls far short of the Cave Review's recommended starting point of 3% of turnover that negotiated settlements - between customer representatives and monopoly suppliers - could apply to price limits. Professor Cave proposed that these settlements be used to give customers a stronger role in price setting<sup>10</sup>.

Finally, a higher level of penalty would be in line with the level of service quality incentives in other sectors. Airports can be required to pay up to 7% of airport charges in the form of rebates to airlines according to performance on indicators such as queuing, flight information and seating availability<sup>11</sup>. Electricity network operators (DNOs) can be required to pay up to 1.2% of revenue for customer supply interruptions, 1.8% for 'customer minutes lost' (supply) and up to 1% for overall customer experience<sup>12</sup>. Which? considers that this broader measurement of customer experience should be applied to the water sector - see our response to Question 5.

### ***Question 5: 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.*

<sup>8</sup> Companies' performance 2012-13, Ofwat.

<sup>9</sup> Service Incentive Mechanism - a consultation on moving forward from the Overall Performance Assessment: An Ofwat consultation paper, Consumer Council for Water response, October 2009.

<sup>10</sup> Independent Review of Competition and Innovation in Water Markets: Final report, Professor Martin Cave, April 2009.

<sup>11</sup> See, for example, Heathrow airport's scheme at <http://www.heathrowairport.com/about-us/company-news-and-information/performance/airport-operations/service-quality-rebate-scheme>

<sup>12</sup> See <https://www.ofgem.gov.uk/electricity/distribution-networks/network-price-controls/quality-service>



In terms of immediate changes to the SIM as part of the PR14 price review, Which? prefers Option 2 (shifting the balance towards more quantitative measures). Which? takes ‘qualitative’ to mean the survey that tracks customer satisfaction scores with the quality of service delivery, as opposed to the customer handling metrics reported by the companies (quantitative). The aim of the SIM is to ensure that companies are meeting consumers’ expectations. The best way to do this is through measuring consumer satisfaction.

Yet, even with this change, and the other detailed changes we propose (see our response to Question 6), the SIM does not do enough to incentivise companies to improve. As we have set out above, we consider that reforming the structure will help improve the SIM but changes must also be made to what is measured. The current measures fall short on three counts:

1. It measures service only with customers who contact their supplier. CCW’s latest tracking survey found that only 12% of customers said they had contacted their water and/or sewerage company to make an enquiry in the previous 12 months<sup>13</sup>. The SIM only therefore measures service performance with a very small proportion of customers; and
2. The quantitative and qualitative elements are too narrow, focusing on only three metrics - handling of telephone calls and complaints (quantitative) and customer satisfaction with contact with the company (qualitative).
3. The limited way in which certain metrics are measured. Simply asking consumers how they felt about how their complaint or other contact was handled does not give a complete picture.

To address these weaknesses, in the longer term we propose a shift to a three- or potentially four- part SIM:

- 1) Experience and satisfaction of consumers who have had contact with their water provider;
- 2) A broader measure of satisfaction with a representative group of water customers;
- 3) Complaints resolution rates; and
- 4) Potentially, a score for an assessment of any customer services incentives in place within the company for staff and/or senior management.

The objective should be for a broader experience of customer experience than the SIM but, unlike the SIM’s predecessor, the Overall Performance Agreement, the incentive should focus on customer satisfaction.

Alongside gathering the experiences of consumers who have contacted their water provider, there should be a broader measure of general customer satisfaction through a survey of a representative sample of all customers. The survey could include issues such as clarity and accuracy of bills, ease of access to information (e.g. water saving advice, contact details, how to make a complaint). Some of this data is already included in CCW’s annual household tracking surveys on how satisfied customers were with contact with their supplier, both in general and on specific issues such as ‘ease of contacting someone who was able to help you’ and ‘quality/clarity of information provided’<sup>14</sup>.

<sup>13</sup> Annual Tracker Survey 2012, Report by Accent for Consumer Council for Water, June 2013.

<sup>14</sup> Annual Tracker Survey 2012, Report by Accent for Consumer Council for Water, June 2013, pages 30-32.



It is also valuable to assess how well a provider handled a consumer complaint from a consumer satisfaction perspective (see question 6). To complement this, it is crucial to monitor complaint levels and resolution rates. We would recommend the introduction of complaints reporting to include:

- Number of complaints per 100,000 households;
- Cause of complaints;
- Number of complaints resolved after 24 hours, 4 weeks and 8 weeks
- Number of complaints referred to CCW.

### ***Question 6: 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. [options 0, 1, 2 and 3]***

As stated above, Which? recommends that Ofwat work towards a measure that reflects customer satisfaction more broadly to provide a better and more representative measure of customer service (see our response to Question 5).

If broader changes are not feasible in time for implementation for PR14, Which? prefers a modified version of Option 2. However, the qualitative component should have a greater emphasis on complaints and less emphasis on contacts of a ‘transactional’ nature, such as ‘simple’ queries around bills that are not categorised as complaints. Only 13% of contacts last year were identified as a complaint<sup>15</sup>. Customer satisfaction with the rate of resolution of complaints should also be measured and will complement the better complaints reporting set out above.

In addition, we propose the following immediate changes:

- The quantitative element should include the time taken to resolve complaints to incentivise providers to deal with them speedily. We recommend that the companies should report this to Ofwat, along with the type of complaints.
- The notice period given to call centres before the survey should be removed. It is not appropriate that call centres receive notice: the objective should be to ensure that the survey conditions are as close to a normal operating day as possible; and
- The horizontal audit of company reporting by Halcrow in 2011 highlighted some inconsistencies and weaknesses in reporting, yet the consultation fails to address these. This omission should be addressed through application of the report’s recommendations.

### ***Question 7: Design issue 5 - use of absolute or relative performance***

***We invite views on:***

- ***option 1 - retaining the current relative incentive structure; or***

<sup>15</sup> Ofwat SIM survey: 2012/13 Annual report, McCallum Layton for Ofwat.



- ***option 2 - using absolute performance levels to set rewards and penalties (with suggestions of how we might set these).***

We recommend, if possible, an absolute SIM. Ofwat's new risk and reward guidance recognises that 'from a company's perspective, the SIM is inherently uncertain because the amount of reward/penalty depends not only its own performance, but also on the performance of peer companies'<sup>16</sup>. Introducing an absolute approach would remove this uncertainty. An absolute incentive also the benefit that poor-performing companies receive a penalty if their level of service is 'poor', no matter what the performance of their peers. Which? disagrees that setting an 'acceptable' or 'target' level of customer service is a disproportionate regulatory intervention when the incentive provides only a limited price adjustment.

The consultation states that setting a meaningful absolute measure in advance is 'virtually impossible' because the SIM is being re-focussed on household customers only and because Ofwat has limited data to benchmark against. Which? is not clear why it is the case that there is no data. Ofwat could use data from CCW's annual household tracking surveys (see our response to Question 5) and combine this with the companies' own data collected for the SIM to date. Ofwat should start to collect whatever additional data is needed to enable it to define a 'target'.

From an assessment of the relative performance of the companies and the trend over recent years, Ofwat could then make a judgment based on where the bar should be set for 'poor' or 'good' service to be sufficiently stretching to drive improvements. To ensure continuous improvement, the bar should be reset every two to three years as performance improves. The penalty could then be applied, on a sliding scale, to all companies below the bar. By regularly reviewing and resetting the target, this can help improve service across all providers not just the poorest performers.

Comparison with other companies in the sector would still be possible with an absolute incentive. Benchmarking with other sectors is probably of limited value: the energy sector is probably the closest market but it sets too low a benchmark.

If for some reason an absolute approach is not feasible, it is important that the threshold for the maximum penalty is set well within the bounds of current SIM scores so that it is a genuine penalty applied to the poorest performers. In order to incentivise companies to be among the best performers, the high performers should not receive a penalty and only the very best should be eligible for reward - but then only if the case for reward has been made (see further our response to Question 3).

### ***Question 8: Design issue 6 - non-household SIM design for Wales***

No comment.

Which?

February 2014

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<sup>16</sup> Setting price controls for 2015-20 - risk and reward guidance, Ofwat, January 2014.