

THE FUTURE OF THE SERVICE INCENTIVE MECHANISM

A report for Affinity Water

May 2016



Rob Francis



020 7031 7000



rob.francis@frontier-economics.com

Anna Berry



020 7031 7000



anna.berry@frontier-economics.com

Frontier Economics Ltd is a member of the Frontier Economics network, which consists of two separate companies based in Europe (Frontier Economics Ltd, with offices in Brussels, Cologne, Dublin, London & Madrid) and Australia (Frontier Economics Pty Ltd, with offices in Melbourne & Sydney). Both companies are independently owned, and legal commitments entered into by one company do not impose any obligations on the other company in the network. All views expressed in this document are the views of Frontier Economics Ltd.

CONTENTS

Foreword from Affinity Water	1
Executive Summary	2
1 Introduction and Context	3
1.1 Background to the Service Incentive Mechanism	3
1.2 Potential future challenges	4
2 Implication of new communication channels	6
2.1 Trends in communication channels	6
2.2 Implications of multi-channel communication for water companies	9
2.3 Further opportunities in the development of customer performance incentives	12
3 Way Forward and options	15

FOREWORD FROM AFFINITY WATER



In my view SIM has probably exceeded its original intentions and ambitions. There is no doubt that the water industry has become much more focused on customer satisfaction and this is reflected in the results, where we have seen improvements and significant convergence across the industry.

Affinity Water is committed to understanding and delivering great customer service and has fully embraced SIM. With customer behaviours and digital trends changing fast, we need to consider how measuring customer service needs to evolve, particularly when faced with potential household retail competition. This is a truly exciting time and presents us with the opportunity to re-shape our thinking to seek valuable feedback from our customers across a basket of measures that ultimately drives continued service and brand improvements.



Amanda Reynolds, Director of Customer Relations (Household), Affinity Water



The nature of customer interaction and service experience is moving faster than ever with the adoption of digital tools such as smartphones. It is vital that regulatory mechanisms keep pace with this change by incentivising the services customers expect both now and in the future. This paper provides insight into how this could be achieved and proposes a potential approach for the 'Son of SIM'.



Christopher Offer, Director of Regulation, Affinity Water

EXECUTIVE SUMMARY

Ofwat regulates the quality of retail customer service through the use of the Service Incentive Mechanism (SIM). The mechanism has been effective in focusing water company efforts on improving customer service performance. It is appropriate though to consider the suitability of the current SIM structure looking ahead. Affinity Water has asked us to consider how SIM could evolve based on potential changes to customer behaviours and the industry landscape.

Since the SIM was designed by Ofwat, a number of changes have taken place in the way that customers communicate with companies, and in the structure of the water industry. We have considered the following potential challenges:

- growth of new communication channels (e.g. web-chat and social media);
- the split between the wholesale and retail arms of the water companies, and the potential introduction of household retail competition; and
- the appropriateness of the strength of the incentive.

We considered what implications these challenges might have on the qualitative and quantitative elements of the SIM, including considering what questions should be asked to test how well companies are doing in relation to customer service, and to better understand how companies can improve in this area.

We consider that any future SIM or replacement mechanism should be mindful of these challenges, and provide below a summary of our proposed options for the way forward.

- **Mechanism should reflect new communication channels.** Any future mechanism should take account of the growth in new communication channels to help ensure that the mechanism supports innovation in this area and does not provide distorting incentives.
- **Less reliance on quantitative areas.** As it is likely to become harder to consistently compare quantitative measures in future, any future mechanism should involve less reliance on these measures. This approach would also ensure that customer views, as opposed to the outcomes reflected in the quantitative measures, are at the forefront.
- **Developing the qualitative measures.** We consider that any future surveys should reflect best practice in other sectors, including: increasing the number of customers surveyed and the survey frequency; reflecting new communication channels in the survey method; and using behavioural economics to improve survey validity (e.g. by considering how questions are asked).
- **Separate measuring and reporting for vulnerable groups.** Multiple sets of customers could be surveyed on different aspects of service.

1 INTRODUCTION AND CONTEXT

Ofwat introduced the Service Incentive Mechanism (SIM) in April 2010. The mechanism has been effective in the years since it was introduced in focussing water company efforts on improving customer service performance. At the same time, it is appropriate to consider the suitability of the current SIM structure over the years ahead, particularly in the light of the emergence of new communication channels and consider the case to move from specific outcomes of unwanted customer contacts and complaints to an all-embracing measure of customer satisfaction

Affinity Water has asked us to consider the current SIM methodology. The aim of this paper is to consider changes in the customer service environment and wider changes in the water industry, and then to assess the potential implications of these changes on the SIM from 2020 onwards.

1.1 Background to the Service Incentive Mechanism

Ofwat regulates the quality of retail customer service through the use of the SIM incentive. The SIM is designed to encourage water companies to provide better service to customers. It also allows Ofwat, customers and other stakeholders to compare the performance of their company with others in the industry.

The SIM score is comprised of two elements:

- qualitative research on customer satisfaction levels using surveys of customers who have had recent contact with their water company and;
- a quantitative assessment of the number of complaints a company receives, with escalated complaints receiving a progressively higher weighting.

Each company is given a score out of 100 (their SIM score), which is derived by combining the qualitative and quantitative assessments. The SIM is a comparative performance measure which either rewards or penalises water companies dependent on their recorded performance. The reward cap is 6% of retail revenue and the penalty cap is 12% of retail revenue. This incentive mechanism is based on performance relative to the industry average. Ofwat uses standard deviations from the average to determine the value of any reward or penalty.

The SIM replaced an earlier customer service incentive called the ‘overall performance assessment’ or OPA. The OPA was similar to the SIM in that it provided an overall company score measured on a number of metrics and provided financial rewards to higher performing companies and financial penalties to the poorer performing companies.

Ofwat decided to replace the OPA with the SIM for the following reasons¹:

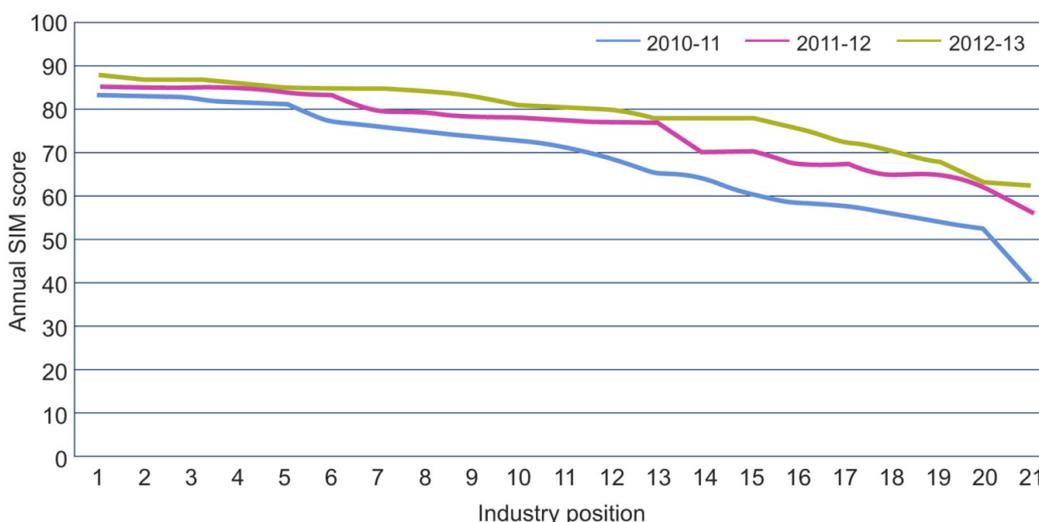
- the OPA metrics focussed on reliability and response times, they did not measure the quality of the company’s response;

¹ Ofwat, *Putting customers first – the service incentive mechanism*, March 2010.

- the OPA metrics were very specific and did not reflect innovative solutions, and therefore were not considered to be flexible enough; and
- the OPA was becoming less effective at incentivising improvements as most companies had reached acceptable levels for the individual measures.

Ofwat reviewed the performance of the SIM incentive during PR14 and consulted on the appropriate structure for SIM for the period to 2020. Exhibit 1 below, from the Ofwat consultation, showed the performance of the mechanism in the first three years. It showed that average SIM scores had improved and also that there had been significant convergence across the industry.

Exhibit 1. SIM rankings 2010/11 to 2012/13



Source: Ofwat, *Service Incentive Mechanism (SIM) for 2015 onwards – a consultation*, Figure 5

Ofwat confirmed that the SIM for 2015-20 would be similar in structure and form to the original SIM structure, but with more weight on the qualitative versus quantitative measures. The weight attached to the qualitative measures would increase from 50% to 75%. There were further minor amendments, for example, changes to the survey design and removing the notice period for the qualitative survey.

The history of both the OPA and the SIM shows that these incentive schemes have been effective at driving improvements in customer service performance. It also shows that it is important to review the design of the mechanism on a periodic basis and to revise the incentive to reflect the current performance in the sector as well as developments in customer service technologies and innovation.

1.2 Potential future challenges

Since the SIM was designed by Ofwat, a number of changes have taken place in the way that customers are able to communicate with companies, and in the structure of the water industry. These changes may present challenges to the future effectiveness of the SIM. We have reviewed these potential challenges and provide a brief overview of how we consider they may affect the operation of the SIM below.

- **New communication channels.** The take-up of new communication channels, such as web-chat and social media (e.g. Twitter), means that the current SIM methodology may not accurately reflect the communication between customers and water companies. In particular, the current SIM may not accurately record the level of communication between water companies and customers, or the level of customer satisfaction associated with that communication. At present it may also not provide companies with the right incentives to drive improvements in customer service on these new communication channels.
- **Split between wholesale and retail.** The water industry is increasingly separating the wholesale and retail arms of the business. This means that total costs are allocated to the separate businesses, and all performance mechanisms such as the SIM could also be split between the retail and wholesale businesses. An option would be for the SIM to be entirely focused on the retail arm of the business, however, on a practical level it may be hard to split customer satisfaction out between these two elements. Another option would be to explicitly gain customer views on both elements of the business, which could provide actionable insights for the individual parts of the business.
- **Household competition.** The Government has stated that it would like to introduce competition for household retail services in England. Any future introduction of competition would need to be reflected in the design of any service mechanism. Looking further into the future, Ofwat should consider whether it feels it is necessary to maintain a financial incentive mechanism on customer service, if the household retail sector were to become competitive.
- **Strength of incentive.** The SIM currently amounts to a maximum potential upside of 6% of household retail revenues, and a maximum potential penalty of 12% of household retail revenues. Given the changes to the structure of the water industry identified above, and current customer service levels, it may be appropriate to re-consider the scale of the SIM. While considering the scale of any future service mechanism, thought should be given to what the appropriate sample size for the surveys would be, to ensure the sample size is balanced with the scale of the incentive.

The potential impacts of these changes on the SIM are considered in more detail in this paper. We first set out what implications these changes may have on the SIM. We then propose some potential options and issues to consider for the future development of the SIM, or some alternative incentive mechanism.

2 IMPLICATION OF NEW COMMUNICATION CHANNELS

The quantitative measures in the current SIM structure covers written complaints (email and letter) and unwanted telephone contacts. The SIM does not include new communications channels such as web-chat and social media.

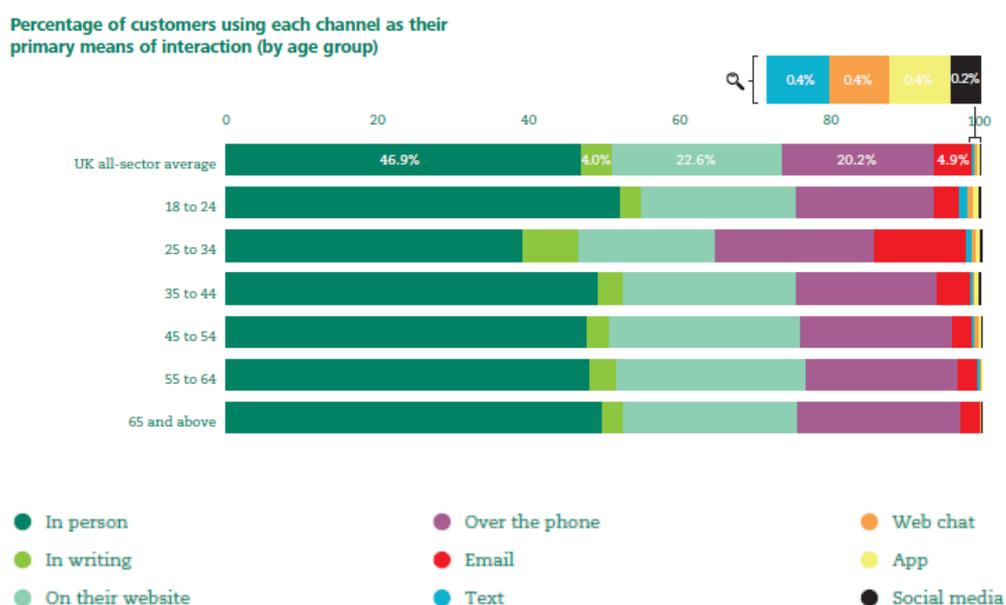
In this section we consider the general trends in the adoption of these new communication channels and the implications for the SIM.

2.1 Trends in communication channels

The Institute of Customer Service identified the use of both traditional and new communication channels as one of the key trends for 2016. It stated that “customers now expect to interact with organisations in the way they choose...there will be a heightened focus for organisations to bring together online and offline experiences so that they are complementary and indistinguishable”.² This conclusion was supported by evidence on what channels customers tend to use when contacting companies. For example, The Institute of Customer Service published the proportion of customers that use each communication channel, by industry and by age.

The chart below shows the split of communication by channel at the UK average, across various age categories.

Exhibit 2. Percentage of customers using each communication channel as primary means of interaction, by age group



Source: Institute of Customer Service (2016), UK Customer Satisfaction Index: The state of customer satisfaction in the UK, p. 27

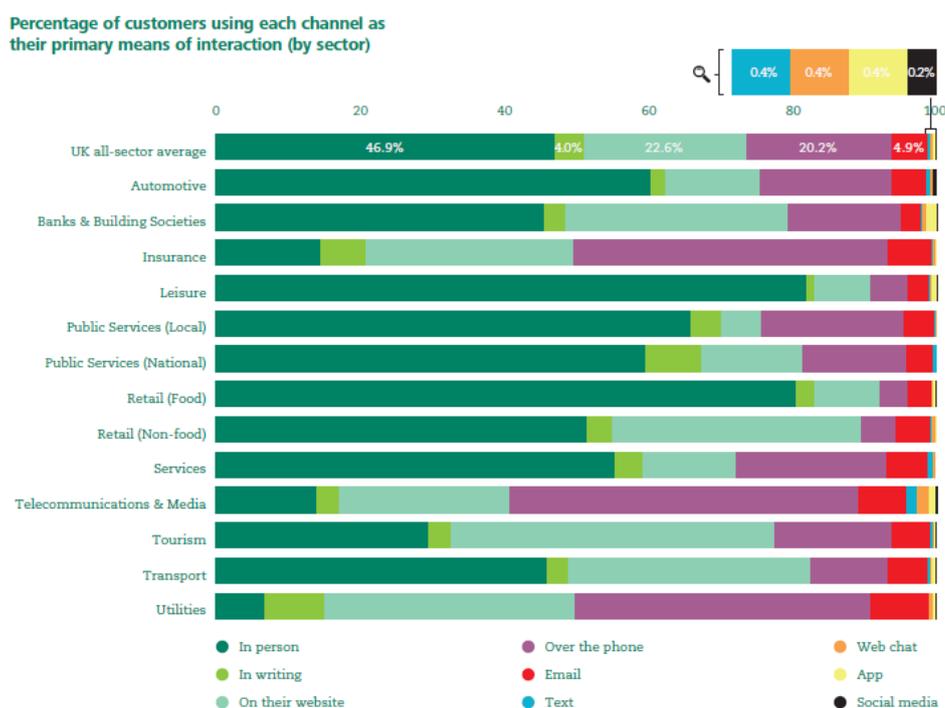
² Institute of Customer Service (2016), Customer Service Trends: What 2016 will bring

This chart shows that:

- a small minority (1.4%) of customers use new forms of communication (text, web-chat, apps, social media) as the primary means of interaction at the UK average level;
- a larger group of customers (22.6%) are relying on interactions on company websites; and
- that traditional means of communication, including face-to-face interactions and over the telephone, are still dominating the way that customers interact, with over 68% of customers choosing those methods.

The Institute of Customer Service also publishes this information by sector, which is shown in the chart below.

Exhibit 3. Percentage of customers using each communication channel as primary means of interaction, by age group



Source: Institute of Customer Service (2016), UK Customer Satisfaction Index: The state of customer satisfaction in the UK, p. 27

This chart shows that:

- the use of new communication channels in the utilities sector is roughly in-line with the UK average;
- within those four new options, web-chat appears to be the most popular option for communication with utilities companies;
- the majority of utilities customers currently choose to interact on the website, or over the telephone; and
- a larger proportion of utilities customers choose to use email as the primary means of communication, when compared to the UK average.

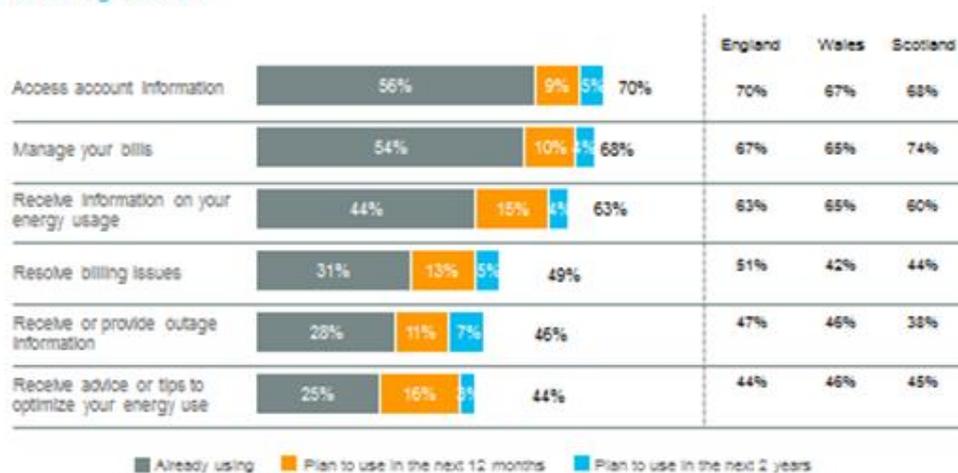
The Institute of Customer Services also provides evidence on the amount of communication channels that customer use. The majority of utilities customers (57.7%) choose to rely on only one communication channel, while just over 7% of customers use three or more channels, which is roughly in-line with the behaviour of the UK average customer.³

Overall this evidence shows that traditional channels of communication are still dominating at present. However, the shift to using these new forms of communication does appear to be a growing trend, because the newer forms of communication appear more popular among certain age categories. Exhibit 2 shows that, when compared to the UK average, 18 – 24 year olds and 25 – 34 year olds use these newer forms of communication more as their primary means of communication. The survey group of 25 – 34 year olds also appear to communicate more via email than the other age categories. If this age dynamic remains the same over time, there is likely to be a growing trend in the use of these newer forms of communication (text, web-chat, apps, social media).

This evidence shows that, although the pace of growth in new communication channels is uncertain, it is clear that these new channels will grow in importance over time. Further research from Accenture supports this, with over half of customers in Accenture’s research survey suggesting that they already use digital channels, or plan to use digital channels for the majority of interactions with their energy supplier within the next two years. The results of this particular survey question are shown in the exhibit below. Although this survey is focused on interactions with energy suppliers, rather than water companies, the results are likely to provide a good indication of the way these customers plan to interact with their water supplier.

Exhibit 4. Results from Accenture survey on use of digital channels

Are you already using or do you plan to use digital channels (i.e., online websites/mobile applications) for the majority of your interactions with your energy provider for each of the following actions?



Base: All UK respondents
Copyright © 2019 Accenture. All rights reserved.

Source: Accenture

³ Institute of Customer Service (2016), UK Customer Satisfaction Index: The state of customer satisfaction in the UK, p. 31

Taking this into account, any future customer service mechanism in the water industry should be able to reflect these emerging trends in communication channels.

2.2 Implications of multi-channel communication for water companies

2.2.1 Impact on quantitative measures

In addition to changing the method of communication, these new technologies may more broadly affect the way that companies communicate with customers, and may therefore have wider implications on water companies. For example, these new channels provide an opportunity for water companies to engage more pro-actively with customers. Companies could publish more information on Twitter about the services they offer and current performance and maintenance activities. This is relatively easy for the company to do, and relatively easy for customers to review and engage with. The ease of communication may therefore mean that companies engage on wider topics than they may currently do. These new channels provide companies with an opportunity to innovate in how they communicate with customers, and what topics they engage on.

New communication channels provide opportunities for more effective and pro-active communication between companies and customers. However, it is important to consider the wider implications of the use of new communication channels. The implications could include the following.

- If some customers find it easier to contact their water company using these new channels, they may make contact more frequently, and on issues that they would not previously have contacted the water company on. As a result, the number of 'unwanted' contacts may increase, even in the context of improved customer communications and greater customer satisfaction.
- Customers may choose to use different communication channels for different types of contacts. It might be that customers choose to use the newer communication channels for relatively straightforward contacts and continue to use traditional methods such as the telephone for the more complex contacts. This may have implications for the weightings attached to the different methods of communication.

The way that customers choose to use these new communication channels is likely to be affected by their dealings with other organisations. As there is not household competition at present in the water industry, household customers may not be aware of what customer service levels are provided by other water companies. As a result of this, customer expectations are likely to be influenced more by their dealings with organisations, such as other utility providers, banks and retailers. If over time these sorts of organisations are actively working to change the way they communicate with customers, and are innovatively using

new communication channels, customers may expect water companies to offer these options as well.

All of this suggests that the new communication channels could affect the number of contacts that customers make with water companies, the way that customers and companies interact, and the expectations that customers have of their water companies. These changes are therefore likely to add complexity to the way that communication between customers and water companies should be measured in future.

A relatively simple measure of unwanted contacts may not provide an accurate reflection of the communication between water companies and customers in future. For example, if the ease of communication increases, companies may receive more unwanted contacts, but the level of customer satisfaction could increase if customers feel their concerns are being listened to more. Similarly, if companies engage more pro-actively on wider topics than before, the number of contacts may increase, and customer satisfaction may improve, but this would not be reflected in the measure of unwanted contacts. Experience from retailers that make use of new communication channels is that it becomes more common for queries to result in escalation of the contact (i.e. if the query cannot be solved simply on the website or web-chat then it is escalated to a phone contact). This trend may therefore result in multiple contacts being recorded, but not necessarily reflect a lower level of customer satisfaction. As a result of these potential changes in customer behaviour, a simple measure of unwanted contacts is likely to be flawed.

A measure of unwanted contacts that does not fully reflect all communication channels may also result in unintended consequences. The quantitative element of SIM does not currently measure web-chat and social media. This could provide an incentive for companies to encourage customers to use these methods of communication when they have any sort of issue that may be classified by the SIM as an unwanted contact.

Overall, the emergence of new communication channels has two important implications for the design of a customer performance incentive.

- First, it is important that the incentive mechanism has the flexibility to reflect innovative use of new communication channels to address customer satisfaction.
- Second, there may be an increase in both customer contacts as well as customer satisfaction. In this case, measuring unwanted contacts would not be sufficient as a measure of customer satisfaction.

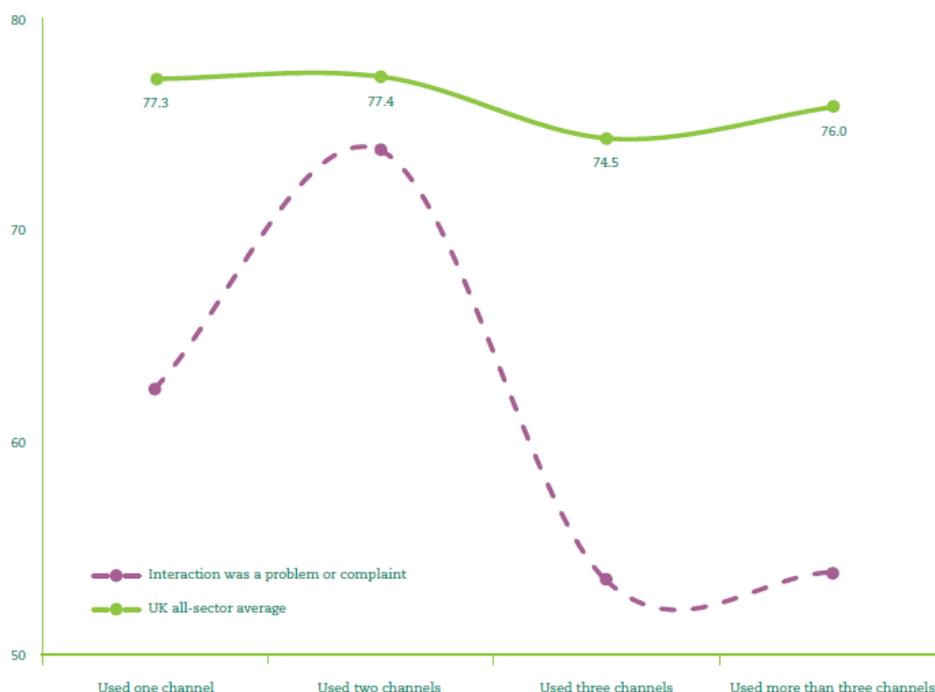
2.2.2 Impact on customer satisfaction measures

The current SIM methodology measures customer satisfaction through qualitative research. However, we have highlighted that customer satisfaction levels may be affected by the shift to using new communication channels. For example, customer satisfaction may vary depending on which channel is used and on how many channels a customer typically uses. The Institute of Customer Service noted that “customers who use a range of different channels for activities such as

checking account information, getting a quote, making an enquiry or purchase give relatively high satisfaction scores...customers who used three or more channels were much more likely to say that they had experienced a problem with the organisation in the previous three months...use of multiple channels may be an indicator that a problem or complaint has not been resolved”.⁴ The chart below shows how satisfaction levels vary across the number communication channels that are used.

Exhibit 5. Satisfaction levels recorded by the number of communication channels used

Where customers experience a problem or complaint, use of three channels or more may be an indicator of dissatisfaction.



Source: Institute of Customer Service (2016), UK Customer Satisfaction Index: The state of customer satisfaction in the UK, p. 33

This chart shows that satisfaction levels dip significantly when a customer that is making a complaint uses more than two channels. Any measure of customer satisfaction should therefore be developed to reflect the types of channels used and the number of channels used.

More generally, it seems plausible that certain channels are more appropriate for certain types of contact, and that companies should be able to provide a range of different channels to enhance customer satisfaction across all communication. The Institute of Customer Service suggests that it is “vital for organisations to understand the factors that drive customers’ channel preferences and usage...organisations need to offer a consistent level of experience across all

⁴ Institute of Customer Service (2016), UK Customer Satisfaction Index: The state of customer satisfaction in the UK, p. 33

channels and measure both the effectiveness of individual channels and the quality of the overall customer experience”.⁵

In conclusion, the implications of new communication channels are such that simple measures of the number of unwanted contacts are likely to become flawed in future. Given the changing nature of the way that customers and water companies are likely to communicate in future, it does not seem appropriate to attempt to find an alternative quantitative measure to replace the current one in the SIM. Instead it would seem reasonable that more focus, if not a 100% focus⁶, should be given to satisfaction scores when monitoring customer service in the water industry. The assessment of customer satisfaction should be wide reaching, and record satisfaction across a range of different communication channels.

2.3 Further opportunities in the development of customer performance incentives

In this section we identify how wider changes to the water industry may present challenges for the effectiveness of the SIM in the future. We also incorporate lessons from other sectors to help identify options to enhance customer performance incentives.

2.3.1 Retail / wholesale separation

Water companies are now required to allocate costs between these two parts of their businesses, and Ofwat set separate price controls at PR14. With increasing separation, there is a case for incentive mechanisms to be allocated either entirely to one part of the business or split between these two separate parts. It would seem logical for SIM to be entirely allocated to the retail part of the business. In practice though, it might be difficult to separate out retail-related contacts and wholesale-related contacts. For example, a customer may contact a water company with a question about an aspect of their wholesale service. While this is a wholesale-related question, it could be argued that the retail arm of the business could provide some level of service on this, such as helpful and timely information.

Given this issue, a qualitative approach could be more effective as it monitors customer satisfaction more broadly. A qualitative survey provides an all-encompassing view of customer satisfaction, whereas a quantitative measure may need to be explicitly split into wholesale and retail related contacts.

At present the importance of this issue may not be significant, as the wholesale and retail arms of the business are still owned by the same company. This means that any financial impact of the SIM, or a replacement customer service mechanism, would be felt by the same organisation, regardless of what the customer has contacted about. It may however become more of an important

⁵ Institute of Customer Service (2016), UK Customer Satisfaction Index: The state of customer satisfaction in the UK, p. 46

⁶ The current quantitative measure also includes CC Water investigations. There could be a case to retain this measure alongside qualitative satisfaction measures.

issue if household competition is introduced or if more formal separation of wholesale and retail activities is mandated.

2.3.2 Lessons from ODIs and other sectors

An enhanced or replacement SIM should reflect the lessons learned from the development of retail Outcome Delivery Incentives (ODIs) as well as experience in other sectors.

- **Retail performance commitments (PCs) and ODIs at PR14.** Water companies had the chance to include PCs and ODIs that related to customer service at PR14, in addition to the SIM. Most companies did include additional PCs related to customer service, almost all of which only had reputational incentives. Some companies included their own customer satisfaction and value for money surveys, while others included tracking of the specific satisfaction of vulnerable customers. Where companies applied financial incentives to customer service related measures, these were typically penalty only incentives for failing to roll out new billing systems or customer management systems. Anglian Water also applied a financial incentive to customers' perceptions of affordability, relative to a baseline defined by the other WASCs. This suggests that companies do find it helpful to monitor broader qualitative surveys on customer satisfaction, in addition to the SIM.
- **Financial services.** The Financial Conduct Authority (FCA) regularly conducts thematic reviews into particular issues relating to customer service that may be of concern. As part of these reviews, the FCA may conduct or commission customer research on that particular issue. They may hold focus groups, or conduct in-depth face-to-face interviews to understand customer views on these specific issues in detail. We understand that the FCA also conducts inspections in branches and at contact centres, where it is felt this detailed insight is required. The tool of the "mystery shopper" could also be applied in the water industry, whereby Ofwat could test exactly what the customer experience is like when contacting water companies.
- **Retail sector.** Our understanding is that companies in the retail sector typically survey at least around 100 people, per store, per month. These surveys cover a wide range of issues to provide companies with a reasonable picture of current customer satisfaction levels.

The experience from other sectors indicates that SIM measurements are limited, both in terms of the overall sample size but also the frequency of sampling within the year. Furthermore, adopting the practice of conducting in-depth reviews of performance is likely to generate more specific and actionable insights on customer satisfaction.

2.3.3 Scale of financial incentive

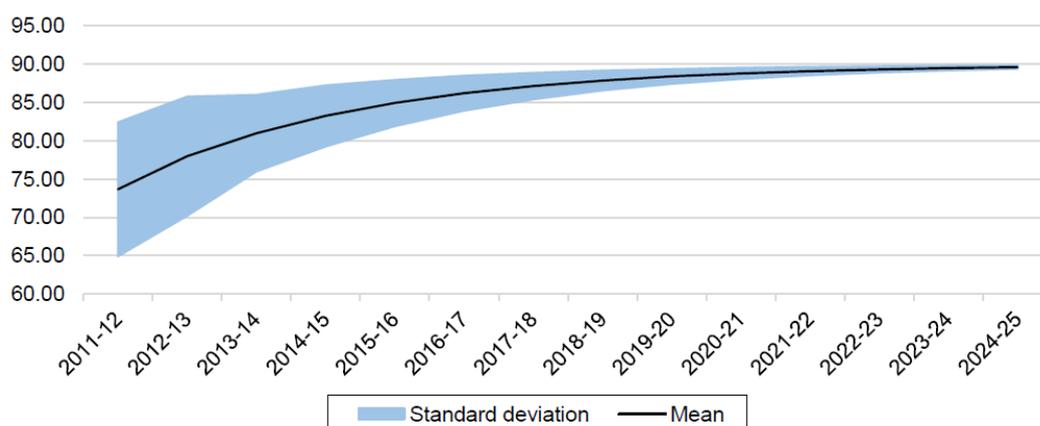
The expected developments in the sector will question whether the scale of the SIM remains appropriate. The current scale amounts to a maximum potential upside of 0.5% of total revenues (6% of household retail revenues), and a maximum potential penalty of 1% of total revenues (12% of household retail

revenues). There is a case for reviewing the scale of the SIM, given the evidence of converging performance across the industry, as well as the potential challenges to effective measurement in future. Exhibit 6 shows the projection in the range of SIM scores, undertaken by the CMA during the assessment of the Pennon and Bournemouth Water merger. The CMA stated that:

“Ofwat submitted that there had been convergence in companies’ SIM scores over the PR09 period and it expected this to continue over the PR14 period. In order to control for likely convergence, we have modelled the degree of previous convergence and used this to forecast the future mean and standard deviation of SIM scores”⁷

The analysis projects a high degree of convergence by 2020, which raises the question of whether the scale of the incentive would be too large in its present form. In other words the difference in performance between a reward and penalty would be much smaller.

Exhibit 6. Convergence in SIM score over time



Source: CMA analysis based on Ofwat data, CMA Pennon / Bournemouth merger inquiry

As the role of any future mechanism would be to encourage innovation and to help spread best practice in customer service, it may not be necessary to apply as large a potential reward or penalty, as when Ofwat was looking to increase customer satisfaction levels when the mechanism was introduced. However, it is also possible that the inclusion of broader measures of customer satisfaction in conjunction with the increase in digital communication channels may offset this projected convergence. This could support the retention of the current incentive rates.

⁷ CMA, Pennon Group and Bournemouth Water, November 2015, Appendix H.

3 WAY FORWARD AND OPTIONS

The growth in the use of new communications channels is well established and it is clear that they will impact the way that water companies communicate with their customers. Any future SIM or a re-defined incentive mechanism should be able to reflect this. In enhancing the SIM or in developing a new mechanism, to more accurately track customer satisfaction, Ofwat should consider the following.

Reflect all communication channels

Ofwat should take account of the growth in the use of new communication channels, and ensure that any future customer service mechanism is updated to reflect the changing nature of communication channels. The mechanism should ensure that it does not provide any distorting incentives on companies to focus efforts on any particular communication channel, but rather to provide multiple options for customers. Any future mechanism should also support innovation in this area, and encourage companies to learn from each other to share best practice on how they can communicate better with customers. Water companies should also be encouraged to learn from the leading sectors on customer service.

Attach a greater weight to qualitative research

Ofwat should consider adapting the way that company performance is measured. The impact of new channels indicates that this should involve less reliance on quantitative measures, as it is likely to become harder to compare consistently in future. Instead the mechanism should attach a greater weight to qualitative measures of customer satisfaction.

One option is to continue to monitor these quantitative measures, and report them in the strategic dashboard, but not to apply any financial incentive on them. If these measures were continued to be used, consideration must be given to how they could be adapted to include new communication channels. For example, the number of overall contacts and complaints could be reported by channel.

Further enhance the qualitative measures

Ofwat should also consider how it can ensure that any future customer satisfaction survey reflects best practice in other sectors, and the changing nature of the water industry. We provide below some potential suggestions for how the survey could be improved.

- Increase the sample size of customers surveyed and the frequency of sampling.
- Use the new communication channels to conduct the survey to help ensure that the survey sample is not biased towards customers who only use certain channels.

- Include surveys that are carried out independently in the water industry. Many companies in the water industry conduct their own customer feedback surveys, separate to surveys related to the SIM. For example, Affinity Water surveyed just under 80,000 customers in 2015/16 to better understand overall satisfaction, and areas for improvement. Ofwat could consider whether the data collected by companies could be used in any new mechanism.
- Include learnings from behavioural economics to help ensure that questions are not leading or frame the customers' responses in any way.
- Add in additional measures relating to loyalty and effort, if household retail competition is introduced. Such questions would be more in-line with metrics that competitive businesses tend to be particularly interested in, such as churn rate and net promoter scores.

Any qualitative measure should be wide-reaching and not focused on one particular issue. The Institute of Customer Service advised that “there is no single measure which predicts the business impact of customer service...organisations are better advised to select a basket of measures which reflects the attitudes of customer experience that are most important to their customers”.⁸ A recent UKWIR study drew a similar conclusion: “there is no single ‘best’ measure. Leading organisations use a combination of measures that fit their needs including: Service Quality; Customer Experience; Customer Effort; and Net Promoter Score”.⁹

Cross-sector comparisons

Ofwat recognised in its 2014 consultation that it may be possible to include external benchmarking in any future incentive mechanism. This may be difficult to do in practice, due to differences in customer perceptions across sectors, but nevertheless information from other sectors could be useful.

Given the potential differences in customer perceptions across sectors, any comparisons would have to be carefully considered. One option would be to limit comparisons to those which only include industries that might in the first instance be considered to have similar customer perceptions. For example, the retail energy market, or retail broadband may be considered closely relevant comparators. In this case, it would seem reasonable for any cross-sector comparisons to influence the scale of any financial reward or penalty.

Another option could be to include a longer list of comparators in the cross-sector assessment, which is likely to result in the inclusion of at least some less relevant comparators. In this case, it might not be appropriate to allow the comparison to influence the scale of the incentive, at least not to any significant degree. In this case though, the behaviour and performance in other sectors could still play a role in driving innovation and best practice in household retail.

⁸ Institute of Customer Service (2016), UK Customer Satisfaction Index: The state of customer satisfaction in the UK, p. 45

⁹ UKIR (2012), Options for refocusing SIM towards a measure based only on consumer satisfaction and perception, Report ref. no. 12/CU/01/6, p. 5

Separate measuring and reporting for vulnerable groups

There could be multiple sets of customers that are surveyed on different aspects of service. For example, a sub-group of vulnerable customers could be surveyed separately, where vulnerable could refer to those who are financially vulnerable, vulnerable for health reasons, or less technically proficient and so have a preference for specific communication channels. Such a survey could be used to find out how helpful companies are for those customers with a different need. This should give insights on the extra support that companies offer these customers, and whether this is sufficient, in addition to the insights provided by more general satisfaction surveys.

A survey of those customers who have not contacted their water company could also be insightful. This survey could consider why the customer has not contacted the company, whether they feel sufficiently informed by the company, and how satisfied they are with the company's performance. We note that if the overall sample size of the survey is larger, it will be more viable to ask specific questions to particular sub-groups of the survey.

Summary

We recognise that Ofwat considered some of these issues as part of its 2014 consultation on the SIM for 2015 onwards. These issues should be re-considered in any future evaluation of the SIM, in light of the further development in communication channels, and the other issues identified in this paper.

Measuring the number of 'unwanted' contacts is likely to become increasingly inaccurate in reading overall customer satisfaction due to the emergence of new communication channels and their adoption by customers to resolve their issues more quickly and satisfactorily. Therefore, SIM should focus more on all-embracing customer satisfaction measures, such as overall satisfaction and ease/effort, as already put into practice in some other industries.

Alongside this review of how the mechanism might measure performance, Ofwat should consider what the appropriate scale of the mechanism might be. Looking further into the future, Ofwat should consider whether it feels it is necessary to maintain a financial incentive mechanism on customer service, if the household retail sector were to become competitive. In this world the role of a mechanism may focus more on customer protection and the provision of information to customers, with the incentives for improved performance coming through the process of competition.

Overall, there are a number of options to consider with this opportunity to evolve the current SIM methodology. We have presented some potential options for how this mechanism could be developed in future, which may help reflect future customer service trends and the wider water industry direction.

