Market Performance Framework

Performance Advisory Group – PAG05

17 August 2022

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Agenda

1	**Welcome**	**Chair**	
2	Actions from previous meeting	Chair	5 Mins
3	Workshop Discussion	Chair	5 Mins
4	ENDORSE: Methods of prioritisation for Activities	Janet Judge	40 Mins
5	REPORT ISSUED: Natural and Regulatory Incentives	Ben Gough	45 Mins
6	INFORMATION: Introduction to Intervention types	Janet Judge	15 Mins
7	Any other business	Chair	5 Mins

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Actions from Previous Meeting (1 of 1)

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NO	Action required	Action by	Action Date
04/01	Potentially no market activity for the following scenario: The issue whereby the sewage retailer thinks it has resolved the problem but cannot action as only the retailer has the CMOS rights - Ongoing	JJ	05/08/22
04/02	PwC's final report to cover how natural incentives effects and interventions on different customer segments has been considered - Closed	BG	05/08/22
04/03	Poll to be sent to members with regards to suggested dates and meeting style options for forthcoming workshop - Update	HF	12/08/22
01/04	Ensure customers have an opportunity to engage in consultations as the MPF programme progresses (consultations currently anticipated to begin in late September) - Noted / Ongoing	AR	14/09/22

Chair
10:10

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Workshop Discussion

Chair
10:05

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ENDORSE: Methods of prioritisation for Activities (1 of 10)
Purpose of PAG 05 review - reminder

- **Feedback was requested on** your **preferred** option for prioritisation of activities (based on risk)
- With a view to **Endorse** in PAG 05 (17 August)

Janet Judge
10:55

ENDORSE: Methods of prioritisation for Activities (2 of 10)
Purpose

- We have an endorsed list of activities that drive successful outcomes in the market – including those that may or may not form part of a future MPF
- We need to ensure interventions are focused on activities that make the biggest difference to the delivery of desired market outcomes
- We need a way to prioritise activities

Janet Judge
10:55

ENDORSE: Methods of prioritisation for Activities (3 of 10)
Prioritisation question

- The way we assessed and rated risks / issues means they have a score of nine, six, four or three, reflecting volume of supply points affected and customer impact
- This scoring and its purpose was endorsed as part of Risk and Issues Tracker workstream
- Focus / concern should be on risks / issues with severity ‘9’ score rather than those with a score of ‘3’ (less material)
- **Would you be comfortable if the MPF left out severity ‘9’ risks / issues?**

Janet Judge
10:55

ENDORSE: Methods of prioritisation for Activities (4 of 10) Options

The options for prioritising activities are based on the (total customer impact and) risk score aligned with the activity from the mapping activities to risk / issues exercise, and are:

- Option one – prioritise activities by number of risks / issues
- Option two – prioritise by number of risks / issues with the highest scores
- Option three – prioritise by the highest combined total risks / issues score
- Option four – (option two and three combined) prioritise by the highest combined total risks / issues score and the number of risks / issues with the highest scores

Janet Judge
10:55

ENDORSE: Methods of prioritisation for Activities (5 of 10)
Implications of prioritisation

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Based on the illustrative example in the pre-reading, the difference in the practical outcome between options two, three and four are limited. However, this may change as the risks evolve or as the risk mapping changes or as new activities are added, e.g., split into two, or removed, e.g., where natural and / or regulatory incentives apply

The scoring gives us a first view of prioritisation, aiding identification of:

- Those activities that are very important (big ticket activities) that the MPF should focus on
- Those that are important but less critical
- Those that are not material

We won't apply interventions on all activities, e.g., where the activity is not material

Judgement may be required on the cut-off for each of the above categories with an opportunity to move activities between them through, for example, rationalisation i.e., risks are covered by another activity. Both activities could be in scope but we could apply the MPF focus on activity two rather than activity one

Janet Judge
10:55

ENDORSE: Methods of prioritisation for Activities (6 of 10)
Comparison of options

Options	1. Quantity-based: Prioritise activities which mitigate the most risks	2a. Individual risk impact-based: Prioritise activities which mitigate the individual risks with the highest scores - severity 'g' risks only	2b. Individual risk impact-based: Prioritise activities which mitigate the individual risks with the highest scores - severity 'g' and '6 risks	2c. Individual risk impact-based: Prioritise activities which mitigate the individual risks with the highest scores - severity 'g', '6' and '4' risks	3. Combined risk-based: Prioritise activities that map to the highest sum of risks scores	4a. Combination of 2 and 3: Prioritise activities that map to the highest sum of risks scores and ensures activities that target risks with high scores are included - sort by total risk score, then by count of severity 'g' risks (further variants possible as per Option 2)	4b. Combination of 2 and 3: Prioritise activities that map to the highest sum of risks scores and ensures activities that target risks with high scores are included - sort by count of severity 'g' risks, then by total risk score (further variants possible as per Option 2)
Features							
Simple	More	More	Less	Less	More	Less	Less
All high-severity risks covered	No	Yes	Yes	Yes	No	Possibly not [1]	Yes
Prioritises activities with most significant effect	No	No	No	No	Yes	Yes	Yes
Helps sort mid-table activities for lighter /heavier touch intervention	No	Yes	Yes	Yes	No	Yes	Yes
Ties resolved	No	No	Yes	Yes	No	Yes	Yes
Decision required on exclusion of activities	Yes	No	No	No	Yes	Yes [1]	No

[1] A decision would be needed on where to draw the line for what 'risk score' would be low enough to exclude an activity from the MPF under option 4(a) – This would then likely exclude some high-severity risks?

Janet Judge
10:55

ENDORSE: Methods of prioritisation for Activities (7 of 10)
Preferred Option

- MOSL's view is that Option 4b is the most practical option
- Slightly more complex (it's a two-factor metric) than the other options but still a simple approach and underlying logic is understandable
- Its advantages are:
  - It prioritises activities that will have the most significant overall impact and ensures all 'high-severity' risks are covered
  - It helps sort mid-table activities for lighter or heavier-touch application of interventions
  - It does not require a decision on where to draw the line on risk scores as any with 'high-severity' meet the cut
- Bear in mind potential for risks, risk-mapping and activities to change over time
- We need to be comfortable from a principles view-point that the approach is right

ENDORSE: Methods of prioritisation for Activities (8 of 10)
Success Criteria supported by option 4b

Facilitate **improved customer outcomes**

- Contributes more to this success criteria than the simpler prioritisation options - prioritises activities with most significant impact and all ‘high-severity’ risks

Ensure the framework is **transparent and proportionate**

- Prioritising activities with the greatest impact and risk is proportionate

Provide an **enduring, agile and responsive** framework

- Covers severity ‘9’ risks then where risks or risk-mapping change over time can choose to cover all severity ‘6’ risks and so on, giving an enduring framework

Janet Judge
10:55

ENDORSE: Methods of prioritisation for Activities (9 of 10)
Summary of feedback on options

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Option 4/4b

- Three PAG members expressed a general (theoretical) preference for option 4/4b

Option 3

- Two members preferred this as simpler and suggested severity 9 risks not covered could be reviewed, may not be a big impact or may be able to be mitigated elsewhere
- One also stated no significant objection to option 4 if optimisation exercise undertaken and methodology clearly explained
- The other thought option 4 seems the most robust but where we draw the line would be needed, and supported further rationalisation of risks and activities

General

- Several respondents felt seeing outcome of the prioritised list would be helpful - does it feel right?

Janet Judge
10:55

ENDORSE: Methods of prioritisation for Activities (10 of 10)

MOSL's view is that Option 4b is the most practical option

We are seeking **Endorsement** of our **preferred** option for prioritisation of activities based on the principles / features of the options

Janet Judge
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What we've shared so far… (1 of 9)

- **PAG02** - Set out the rationale behind our review of Natural & Regulatory Incentives
- **PAG04** - Introduced the types of natural and regulatory incentives we identified, and our assessment approach
- **Today (PAG05)** - We share our findings and recommendations

Ben Gough
11:40

Our high-level approach (2 of 9)

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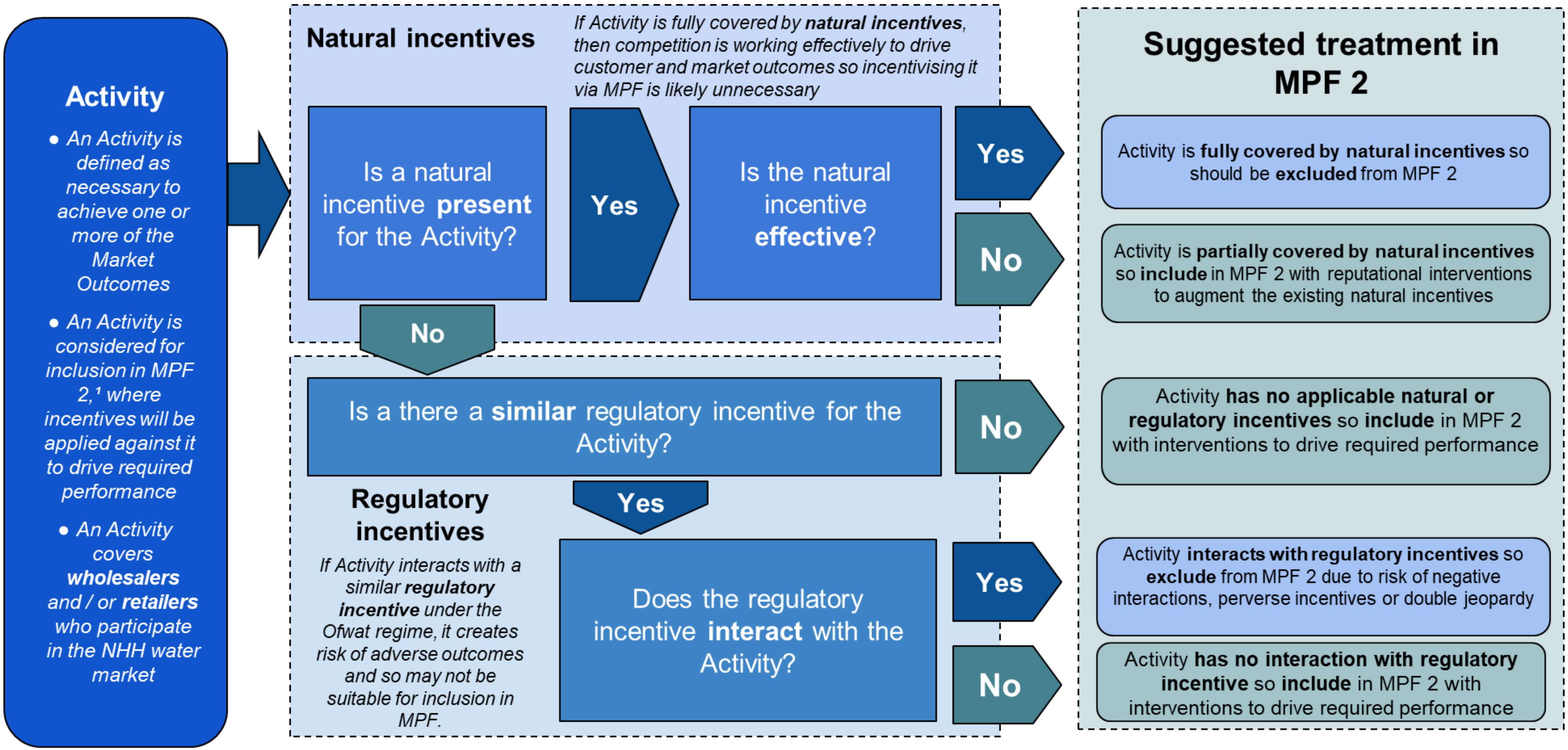

Notes: 1) MPF 2 is the next updated and reformed iteration of the current MPF.

Ben Gough
11:40

Example of how we conducted the assessment for Natural Incentives (3 of 9)

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Activities

In the previous phase of the MPF Reform programme we identified a set of Activities to achieve the outlined outcomes from MPF 2

Natural incentives assessment

The purpose of this exercise is to assess each Activity against the five identified natural incentives to answer the following:

1. Is the incentive **present**, i.e. does it have the ability to impact on the Activity and lead to the desired behavioural changes on participants?
2. Is the natural incentive currently **effective** in doing so?

View on inclusion under the MPF

After understanding whether the right conditions are in place for natural incentives to be effective, we consider whether they could be made more effective through certain kinds of intervention

Example:

GS.3 Retailers resolve complaints in a timely and efficient way

Natural Incentive type	Does this natural incentive influence the outcomes desired by this Activity?	Is it effective in doing so?
Absence of barriers to entry/exit	**Yes.** If there is a pain point[1] in the market (e.g: complaints are not resolved in a timely and efficient way) coupled with absent barriers of entry/exit, there is a likelihood of new entrants emerging with innovative solutions	**No.** The identified pain point is too narrow (i.e limited revenue opportunity) and doesn't seem to require a great extent of innovation, thereby not incentivising new entrants to emerge with new solutions
Ease of and motivation for switching	**Yes**. If customers were actively engaging in switching retailers, it would drive these entities to focus further on customer experience and adapt to evolving needs (e.g: within complaints process). Since the NHH is competitive, firms would act this way in attempts to ensure retention and also target 'new' customers	**No**. In the NHH water market, customers are not engaged and therefore it is unlikely they'll switch based on an improved complaints process from alternative providers.
Willingness to pay for 'premium'	**No.** Resolving complaints in a timely and efficient manner cannot be seen as a premium service, i.e. something customers would be willing to pay more to obtain. This Activity seems to fall under more general customer requirements.	N/A

Inclusion of reputational incentive (public leaderboard of retailers' complain resolution times) might augment natural incentive around switching through giving more information to customers on better performing companies under these measures)

Notes: 1) Specific problems faced by current or prospective customers in a marketplace

Ben Gough
11:40

Example of how we conducted the assessment for Regulatory Incentives (4 of 9)

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Activities	Regulatory incentives assessment	View on inclusion under the MPF
In the previous phase of the MPF Reform programme we identified a set of Activities to achieve the outlined outcomes of the MPF	The purpose of this exercise is to assess each Activity against the identified common performance commitments to answer the following: 1. Is there an **applicable regulatory incentive**, i.e does the Activity clearly align with any of Ofwat's common performance commitments? 1. Does the regulatory incentive have the **ability to impact the Activity** and lead to the desired behavioural changes on participants?	After understanding which Activities are sufficiently covered by regulatory incentives, we consider which Activity groups should be reconsidered for further action.

Example:

UWE.1 Wholesalers to notify retailers when potential supply pipe leaks are identified

Similar regulatory incentive	Rationale	Interaction with Activity (Y/N)	Rationale
Leakage - financial incentive	Ofwat sets leakage reduction targets that wholesalers need to meet; improving leakage controls may support achievement of this target	**No**	Supply pipe leaks do not count towards wholesalers' leakage targets (as supply pipes are part of the customer's property rather than the wholesaler network), so the Ofwat incentive covers a separate area to this Activity and so does not interact

This Activity should be considered for inclusion and incentivisation under MPF 2

Notes: 1) We note that Ofwat are collecting further information from companies to understand the level of consistency of approaches adopted to address leakage on customers' own pipes, and depending on the outcome there may be changes to the way that companies approach business customer supply pipe leakage at PR24.

Ben Gough
11:40

Our findings suggest five groups of Activities that can be considered for intervention in the MPF (5 of 9)

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Framework definition | Incentives assessment | **Activities assessmenta**

1 Wholesale-related Activities with no clearly applicable regulatory incentives

- There are no applicable natural incentives for any wholesale-relative Activities
- Regulatory incentives should prove to be effective when applicable. However, this group includes Activities which don't appear to be clearly aligned to any of Ofwat's common performance commitments, implying these are not covered by regulatory incentives.

2 Retail-related Activities with potential to augment the effectiveness of natural incentives through regulatory incentives

- This group includes Activities where the effectiveness of natural incentives is not sufficient to drive the desired behaviour changes, although this can be augmented through regulatory incentives.
- Given that the latter only applies to wholesalers, there are currently no effective incentive types falling under this group of Activities.

3 Market wide Activities requiring collaboration between market participants

- There are no effective natural or regulatory incentives to influence the Activities requiring collaboration from market participants. This is particularly important considering other requirements e.g sharing data to a set quality standard.

4 Activities without any applicable incentive types

- Some Activities appear to be more closely linked to customer protection measures and/ or reporting standards. In addition, a few Activities are clearly tied to 'key components of the market function'.
- Therefore, there are no applicable natural incentives and no clearly aligned common performance commitments.

5 Activities that are sufficiently covered by incentives

- For this group of Activities, although the applicable natural incentives are ineffective, the regulatory incentives, when applicable, should be sufficient to drive the desired behaviour changes

Ben Gough
11:40

The intervention requirements change across the Activity groups, requiring a tailored intervention for each of them (6 of 9)

Grouping	*Applicable Activities*	*Key takeaways*
Wholesale-related Activities with no clearly applicable regulatory incentives	UWE. 1 (duplicate of CV.3), UWE.7; GS.9	Further action is required via MPF 2 to drive the required behavioural changes, we suggest a form of **financial or reputational intervention** to be considered.
Retail-related Activities with potential to augment the effectiveness of natural incentives through regulatory incentives	UWE. 4,6; GS.2,3,4,7; CV. 2,4,5,6,7,8	Further action is required via MPF 2 to augment the incentives applicable to these Activity. We suggest a form of financial or reputational interventions to be considered (e.g: by exploring a **metric similar to BR-MeX but solely within the NHH retailers interactions with their customers**).
Market wide Activities requiring collaboration between market participants	UWE.5; CV.13, 16	Further action is required to encourage and facilitate collaborative behaviour between wholesalers and retailers. The behaviours will focus getting market participants to make process and data quality improvements, so compliance interventions should generally be suitable.
Activities without any applicable incentive types	UWE. 2, 3, GS.1,6, CV.1,7,17,18,19,20	**Compliance interventions** should be considered to tackle this group of Activities. This is especially the case for Activities linked to 'key components of the market function'.
Activities that are sufficiently covered by incentives	CV.9, GS.5,8,9	In principle, this group of Activities **looks covered by the BR-MeX**, although this is dependent on the finalised definition from Ofwat. Therefore, there is still the potential for intervention via MPF 2 to reinforce BR-Mex. In addition, a **monitoring process** should be established to track the continued effectiveness of these incentives.

Ben Gough
11:40

Our suggestions and recommendations (7 of 9)

Based on our detailed assessment of the Activities against the natural and regulatory incentives, we set out below some high-level suggestions and recommendations as the MPF2 proposals continue to be developed:

- ★ Consider setting financial and / or reputational interventions for group 1 and 2 Activities;
- ★ Consider setting compliance interventions for group 3 and 4 Activities;
- ★ Consider excluding Activities that we believe are sufficiently covered by incentives (group 5), pending on the final BR-MeX definition;
- ★ Consider establishing a monitoring framework for how existing regulatory and natural incentives impact Activities; this could be in the form of establishing and monitoring key “market metrics” (e.g. levels of switching) as part of an annual NHH retail sector review and would act as indicators of whether market outcomes are improving;
- ★ Consider how to facilitate effective collaboration across market participants, including the central systems (e.g. CMOS and Bilateral Hub) and data that could be deployed to maximise benefits whilst ensuring any data is used appropriately and securely;
- ★ Consider establishing a BR-MeX metric to measure the experience of business customers with their retailers; under the Ofwat framework this is currently only applicable to wholesalers.

As the market develops, we suggest Activities are updated to reflect emerging dynamics of the market and then applies all the stages of the assessment described in this report to the new set of Activities.

Ben Gough
11:40

We note a risk of cross-subsidisation across the Ofwat regime and the MPF, which require a set of mitigation measures to limit the risk (8 of 9)

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The risk of cross subsidy	Mitigation measures
• **Cross-subsidy:** There is a risk that wholesalers could cross-subsidise penalties accruing in one framework by increasing charges to customers in the other. This would result in the incentive not being effective as the wholesaler would not be exposed to any financial detriment (it would simply pass the costs on to customers rather than taking a hit to its revenues), and would also mean one set of customers is paying for poor performance experienced by another set of customers. • We believe the **cross-subsidy risk to be at a low to moderate level.** This is because initial revenues and in-period adjustments are monitored by Ofwat, implying it is difficult for market participants to cross-subsidise between the regimes with it being unnoticed for a long period of time. There is a risk of wholesalers misallocating MPF fines as costs to be covered under the PR24 regime, although this would be mitigated through strengthening the existing audit and assurance processes. • However, should penalties be applied to wholesalers via the MPF, they should only be applied to the profit margin component of the charge to NHH retailers; if the penalty also applies to the cost-to-serve component of the charge, then there is a risk that this impacts the wholesalers' ability to deliver services to all customers, whilst only NHH retail customers will see a lower bill. **This would be a de facto cross-subsidy.**	• **Collaboration with Ofwat will be required** to ensure that there are processes in place to prevent this occurring, highlighting to Ofwat any financial incentives under MPF 2, and Ofwat putting in place relevant reporting requirements (e.g. robust and transparent cost reporting such as an **assurance statement from wholesalers around how it has allocated / classified any MPF penalties**). • Any financial incentive proposed under MPF 2 will still need to be carefully calibrated (likely with Ofwat input) such that it does not impact the cost-to-serve to the detriment of all customers.

Ben Gough
11:40

There are potential future developments in the NHH market likely to influence incentives (9 of 9)

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Water sector evolution

The review of Ofwat's PR24 draft methodology[1], the Government's strategic priorities for Ofwat[2] and the Welsh Government priorities for Ofwat[3] suggest that, in the next 5-10 years, the NHH retail water sector is likely to focus on:

- **Increasing environmental and social value**: There is a new net zero challenge funding pot introduced for the 2025 to 2030 regulatory period;
- **Increasing cost efficiency**: Ofwat has view that the current base expenditure is already sufficient to drive improvements in outcomes and maintain asset health;

These two developments will incentivise companies to have more direct control on water consumption.

- **Understanding customers (and communities)**: Ofwat has developed its customer engagement policy for PR24 to address issues experienced at PR19. In addition, and particularly relevant for the NHH market segment, Ofwat introduced a new performance commitment focused on NHH customers (BR-Mex).

Implications for MPF 2 Activities

A focus on consumption management as well as a deeper understanding of customers needs and preference to optimise their satisfaction is likely to:

- Create an incentive for retailers and wholesalers to offer innovative services aimed at reducing consumption or allowing customers to have more control over their consumption;
- Increase customers **willingness to pay** for this kind of **premium services**, triggering a currently ineffective natural incentive.

As HH retailers will be driven to improve their service in light of regulatory incentives (e.g: C-MeX performance commitment), this should lead to higher industry wide standards, which inevitably will also have an knock-on impact on the NHH sector. Therefore, given that HH customers will have higher expectations regarding quality of service, this might also add to the expectations of NHH customers.

These developments should be monitored, including how they influence any related Activities in MPF 2; as the market evolves, it may also be necessary to rerun the incentives assessment to check how and whether affected Activities still need to be incentivised via MPF 2.

Notes: 1) PR24 draft methodology (July 2022). 2) The Government's strategic priorities for Ofwat (Feb 2022). 3) Strategic Priorities and Objectives Statement to Ofwat issued under section 2B of the Water Industry Act 1991 (2017)

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INFORMATION: Introduction to Intervention types (1 of 4)

- Interventions - intercessions of Market Operator or Strategic Panel/committee to change market participant behaviours. Defined by category, type and tool
- Within each intervention type is set of candidate intervention tools
- Tools will be applied to incentivise completion of Activities that support market outcomes
- The intervention types presented in the following slides were developed by MOSL SMEs after initial input from PwC

Janet Judge
11:55

INFORMATION: Introduction to Intervention types (2 of 4)

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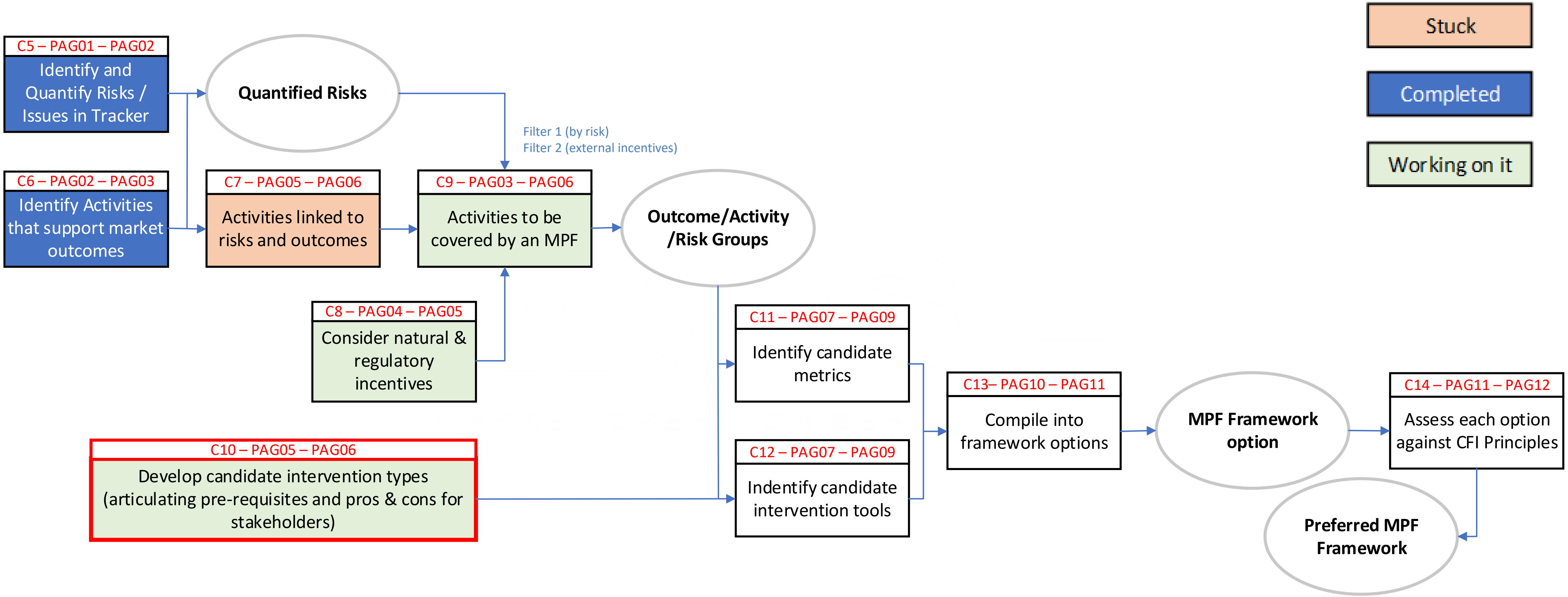
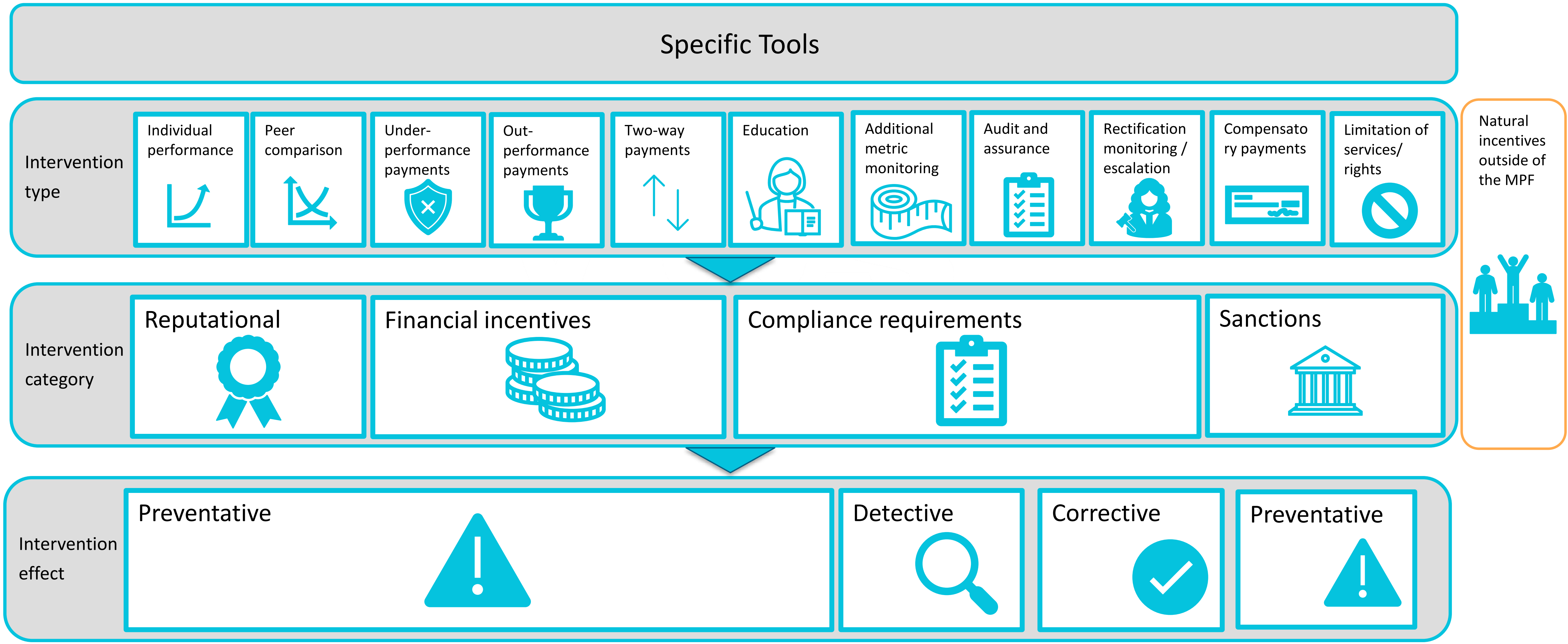


Janet Judge
11:55

INFORMATION: Introduction to Intervention types (3 of 4)
Intervention hierarchy



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11:55

INFORMATION: Introduction to Intervention types (4 of 4)

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Pre-read on intervention types will be sent for feedback in advance of PAG06

- One-page summaries of each intervention type

The one-page summaries include:

- The category and effect of the intervention type
- A description of the intervention type
- Prerequisites for using the intervention
- Comment on the flexibility with which the intervention can be used
- Benefits and drawbacks of the intervention, determined for each stakeholder group

The ask:

- Are they clear / points of clarity
- Any interventions we've missed

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Future meetings (1 of 1)

Meeting Date	Introductions/**Endorsements**
PAG 06 – 31 Aug	**Endorse intervention types**/**Introduce focus areas of MPF (reflecting risk scores and natural/reg incentives)**
PAG 07 – 14 Sept	Review progress to date/ **Endorse focus areas of MPF**/ **Introduction: Process for candidate tools & metrics**

PAG08 – Wed 12 Oct – Institute of water conference

PAG12 – Wed 23 Nov – Code Change Committee

PAG 2023 meetings

Tuesday (fortnightly) – 10:00 to 12:00

Chair