Wholesale Retail Code Change Proposal – Ref CPM018

Modification proposal	Market Arrangements Code Change Proposal – CPM018 – Treatment of MPS & OPS Charges
Decision	The Authority has decided to approve the Proposed Solution of Change Proposal CPM018
Publication date	17 December 2019
Implementation date	1 January 2020

Background

CSD 0002 (Market Performance Framework) defines the processes, methods and incentives designed to support the delivery of satisfactory performance levels within the market by Trading Parties against a set of key performance indicators and obligations. This includes Market Performance Standards (MPS) and Operational Performance standards (OPS) that are in place to monitor and incentivise market activities amongst Retailers and Wholesalers. Their purpose is to ensure the accurate and timely operation of activities within the market, where Retailers and Wholesalers are charged for underperformance against the standards.

The original obligations of CSD 0002 envisaged that in the event of a surplus of MPS and OPS charges paid to the Market Operator (MOSL), MOSL would redistribute the surplus back to Retailers and Wholesalers in the same proportion as they shared Market Operator charges in that financial year.

Amongst other things, CSD 0002 requires the Panel to review the MPS and OPS and has done so via the Market Performance Committee (MPC). The initial recommendation to change the treatment of accrued MPS and OPS charges was submitted to Ofwat in March 2018 ("original CPM008"), proposing to ring fence Wholesaler and Retailer charges into separate 'pots' for redistribution. We returned this proposal back to the Panel in May 2018 for further work to address the weak incentives that original CPM008 would have created for Trading Parties to deliver good performance.

The Panel submitted a revised Change Proposal ("revised CPM008") in November 2018, proposing that for financial year 2019/20, each MPS charging 'pot' would be redistributed according to an algorithm designed to return greater monies than paid in MPS charges to those who performed better against MPS metrics, and less or none to those who performed worse, relative to other TPs. We approved the revised CPM008 in February 2019 as a transitional arrangement, and asked the Panel to develop an enduring solution that would consider:

- Addressing the incentive dilution whereby Trading Parties face reduced incentives to improve performance because of the effects of redistribution; and
- Non-redistribution of charges to prevent diluted incentives.

The issue

The MPC, supported by MOSL, engaged Economic Insight to lead the design of an enduring solution to the ongoing use of the MPS and OPS charges accrued. This included providing an assessment of the original and revised CPM008, previous Ofwat decisions and delivering a recommendation on an enduring solution.

The modification proposal[1]

The solution developed by the MPC is to adopt a hybrid approach for the treatment of MPS and OPS charges accrued. The default position is that 100% of the charges accrued will be redistributed via a relatively simple calculation that avoids diluting incentives on individual Trading Parties (i.e. an incentive-neutral mechanism). It also includes the option to use some or all of the charges to fund special projects where these activities could enhance market functioning or benefit business customers and cannot be addressed by business as usual funding options.

As set out in the Panel's Final Report, the key elements of the hybrid approach are:

- By default, 100% of the charges should be redistributed to Trading Parties in an incentive-neutral approach, which involves a Trading Party receiving only a share of the charges paid by other Trading Parties, not the charges it paid itself. This is referred to as the CPM008+ approach in the Economic Insight Report.
- An option exists to use some or all of OPS and MPS charges to fund special projects, in which case the sum available for redistribution will be reduced.
- The Panel will use pre-defined criteria to exercise the option to use the charges to fund projects. For a project to be funded using OPS or MPS charges, it should:

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[1] The proposal and accompanying documentation is available on the MOSL website at https://www.mosl.co.uk/market-codes/change#scroll-track-a-change

    - enhance market functioning and benefit business customers;
    - be additional to projects that are already envisaged and funded; and
    - deliver broad-based benefits without conferring any significant competitive advantage to individual or small groups of Trading Parties.
- MOSL will support the Panel in project administration by shortlisting the projects and monitoring the progress of projects.
- The deadline for exercising the option to use some or all of the charges will be six (6) months after the end of the financial year.

Accordingly, the Change Proposal makes amendments to the MAC and establishes a 'Project Selection and Governance Document' as an ancillary document to the MAC. This solution would not require changes to CMOS, but MOSL will be required to make changes to its internal processes, including the MPS and OPS redistribution algorithm and calculation, cash flow and supporting the Panel (or sub-group) administering the shortlisting and monitoring of special projects.

There are two sets of draft legal text changes to the MAC. The Proposed Solution assumes that CPM018 is implemented on 1 January 2020 and the Alternative Solution assumes that CPM018 is implemented on 1 April 2020.

Industry consultation and assessment

An industry consultation was published on 23 September 2019 and closed on 7 October 2019. There were a total of 20 responses received, 10 from Wholesalers, 9 from Retailers and from CCWater.

Views on the case for a default redistribution approach and consideration of alternative frameworks

The majority (14 of 20 respondents including 7 Wholesalers and 7 Retailers) agreed the Change Proposal provided an incentive-neutral default redistribution approach.

One Wholesaler who agreed, also stated that they recognised that the removal of the incentive dilution would create a transfer effect that causes unfairness against larger Trading Parties. In the example in the consultation they noted that there was a 50% difference between the percent of charges returned for smaller Retailers compared with the largest Retailer. The Wholesaler suggested that a possible solution would be if a Trading Party has a market share which exceeds 20%, then the size above 20% could be split between the Trading Party's current Org ID and a second Org ID for that Trading Party. Using the example of 32% this would be split 26% for Org ID 1 and 6% for Org ID 2, therefore limiting the transfer effect.

A Wholesaler who did not support the solution, stated that from a very basic bottom line calculation, the impact of the amount of money paid out to Trading Parties is reduced by the amount of money received in. Therefore, the dilution effect still exists regardless of whether the money received in is related to the money paid out or not. The Wholesaler stated that redistribution by market share, whether including a Trading Parties' charges or not, has a risk of disproportionate amounts of redistribution being applied that does not align with a Trading Party's position in the league table. As such, the Wholesaler stated that it would strongly support a bold step away from the market opening premise of redistribution by introducing reinvestment into continuous improvement that benefits customers.

A Wholesaler who also disagreed stated that whilst they were comfortable with the solution, they were concerned by the "skewing" impact based on market share. They stated that a degree of weighting against the larger Trading Parties can be tolerated but they felt that a better balance would be to retain the skewed portion, not distribute this element and use this for special projects. On this basis, the Wholesaler proposed a slight variation to the solution, but recognised that their approach may have other weaknesses.

A further Wholesaler who disagreed stated that they agreed in principle with the solution and that it reduced dilution of performance charges, but raised concerns that the proposal appeared to continue to reward Trading Parties with poor market performance as they will continue to receive rewards in the redistribution mechanism. As such, they highlighted that by basing on market share, Trading Parties with the largest market share but low volumes of task transactions will be rewarded unfairly.

A Retailer that did not support the Change Proposal stated that whilst they agreed with some aspects of the solution, they also strongly believed that the proposed redistribution scheme was not an appropriate mechanism for the market as it is fundamentally unfair and inequitable for Trading Parties, and does not incentivise good market behaviour. The Retailer raised concerns with the financial transfer which would take place between Trading Parties in an equalised performance scenario, which would lead to certain Trading Parties significantly subsidising others purely on market size. They highlighted that this creates a scenario where poor performing Trading Parties could be net beneficiaries, in contrast to relative high performers being the net contributors. The Retailer proposed an alternative proposal to ring fence market share redistribution with a performance-based element. The Retailer stated that such a proposal would give Trading Parties a proportionate share of the total charging pot based on their market share, but this redistribution would then be multiplied by a factor based on the Trading Party's relative performance.

In CCWater's response it was highlighted that from a customer point of view they were generally supportive of the solution as it sharpened incentives for Retailers and Wholesalers. They also stated that they would like the solution to go one-step further, noting that if any monies were returned to Trading Parties then they would like to see it invested into improving customer service, for example where a Trading Party has performed poorly in one or more service areas to the detriment of customers. They also noted that these investments should be made transparent to customers, and the industry.

Response from the Market Performance Committee (MPC)

In the Panel's Final Report, the MPC provided a response to the concerns raised to this question. The MPC noted that some responses suggest that dilution of incentives would still occur, however the MPC stated that they had seen no evidence of this, and therefore remained convinced by the rationale provided by Economic Insight. The MPC acknowledged that CPM018 would create a transfer effect between Trading Parties performing at the same level, purely based on their relative market size. The MPC notes that only under a very large market share concentration (beyond that which currently exists in today's operational environment) that most respondents indicate the transfer would be unacceptable. Furthermore the MPC believes that position is unlikely to arise in the short term and is of the view that under the current operational environment the effect is unlikely to be so large as to distort competition between larger and smaller players. If such a situation is evidenced, or appears likely, then the MPC says it may be appropriate to reconsider the default redistribution approach at a future point. The MPC confirms it will monitor and evaluate the impact of the transfer effect over time.

The MPC also considered the alternative solutions proposed by some respondents to the consultation. The MPC raised the following issues:

- The preference of a majority of the MPC was to avoid a performance driver in the redistribution mechanism given that it is better to have clear ex-ante incentives based on the structure and charging levels of the standards themselves.
- Mandating project funding might risk the selection of projects which were inefficient or with potentially unknown and undesirable outcomes.
- The arbitrary breakpoint for a Trading Party "split" and a perception that the improvement in respect of transfer might not offset re-introduction of dilution of incentives.

The MPC acknowledged that market share based redistribution was not unanimously regarded as the best apportionment key. However, it noted that no better key was suggested, or had been identified, and so the MPC recommended a market share based approach with separate pots for MPS-Retailers, MPS-Wholesalers and OPS.

Views on the case for option to use OPS and MPS charges to fund special projects

The majority (14 of 20 respondents including 7 Wholesalers, 6 Retailers and CCWater) agreed with having an option to use some or all of the charges to fund special projects. A Wholesaler that agreed, stated that whilst they supported this approach they would be comfortable if this was extended to all of the fund being used for special projects. A different Wholesaler who also agreed, stated that it would like to see a significant percentage of the money used to enhance market functionality that would benefit business customers. As such, it was their preference that there should not be criteria to limit excessive spending.

CCWater agreed with the option to use the charges to fund special projects and welcomed transparency in the process of identifying and selecting appropriate projects that will deliver customer benefit. They also stated that they would like assurance that the funding would not be used for projects that should be delivered as ‘business as usual’.

Three responses supported the principle but offered suggestions for setting out more firmly how and when the funds would be spent. For example, a Retailer suggested using the charges to fund innovation research, whilst another stated the criteria for selecting special projects should ensure that projects benefit all non-household customers and consider regional differences.

Three respondents did not support the principle of using MPS and OPS charges to fund projects and cited several main concerns. A Wholesaler stated that this option encouraged unrequired expenditure rather than consideration through a formal mature business planning approach. A Retailer stated that any project to improve the market should be budgeted through the MOSL annual report and there should be a call for tender to suggest and choose the projects to be implemented. A different Retailer stated that the use on projects dilutes the purpose of the charges and it already actively uses the performance charge position as a customer incentive outside of the need to comply with market codes.

Response from the MPC

In response to the concerns raised to this question, the MPC acknowledged the minority view that all monies should be mandated for redistribution. The MPC highlighted that it believed an opportunity would be lost and did not want to eliminate the prospect of project selection, hence the hybrid nature of CPM018. The MPC also advised that it was reluctant to set up potentially expensive and administratively complex independent review groups and preferred a light touch framework with sufficient rigorous governance, defined criteria for selection and with transparent processes and reporting to ensure Panel accountability.

Views on how to treat OPS charges (vs MPS charges) to fund special projects

Thirteen respondents (including 6 Wholesalers, 6 Retailers and CCWater) were supportive of the proposed approach for using OPS charges to fund special projects. Some respondents acknowledged that the reason for collecting OPS was distinct from MPS and that this ought to be taken into account in how the funding of special projects is allocated. One Wholesaler and one Retailer stated that they would of like to see OPS charges spent first to fund special projects and another Wholesaler stated they would like OPS charges not to be redistributed at all.

Seven respondents disagreed with the proposed approach, with one Retailer stating that they fundamentally disagreed with OPS charges being returned to Wholesalers and believed that OPS charges should be returned to the Retailers affected by the OPS failure. A different Wholesaler who also disagreed stated that MPS and OPS charges should be approached in the same way and both should be 100% redistributed. Another Wholesaler stated that there needed to be consistency of OPS reporting across Wholesalers before implementing an OPS redistribution model.

Response from the MPC

The MPC acknowledged the range of views provided on the treatment of OPS charges. The MPC noted that it had previously indicated that Wholesalers should not anticipate redistribution of OPS monies. The MPC noted that delivering on this aspiration would require project selection to use some or all of the OPS monies. As such, the Proposed and Alternative Solutions defines how OPS charges payable in 2019/20, and subsequent years, will be treated. This included the 2019/20 charges being redistributed to Trading Parties, save for any monies allocated to specific projects.

Views on implementation date

If the Proposed Solution is implemented on 1 January 2020 then the first MPS monies to be available for project funding would be from the last quarter of 2019/20. If the Alternative Solution is implemented on 1 April 2020 then the first MPS monies to be available for project funding would be those charged in 2020/21.

There was a split between respondents (10 agreed and 9 disagreed) who preferred that CPM018 be implemented as early as January 2020 versus April 2020. Of those that preferred a January 2020 implementation, their rationale was that CPM018 would drive market improvements earlier. Respondents who preferred April 2020 cited their concerns around the business planning that had already been made for financial year 2019/20, and thus implementing in financial year 2020 would be less disruptive.

Response from the MPC

The MPC noted that respondents' positions indicated no clear preference as to an implementation date or material new evidence to influence such selection. Whilst some MPC Members considered whether a 1 January 2020 implementation might be feasible, others felt that the timelines associated with Ofwat's decision making and MOSL's administrative processes and the work still required on developing a Project Selection and Governance Document might not accommodate a 1 January 2020 implementation. As such, the MPC agreed to recommend an implementation date of 1 April 2020 to the Panel.

Panel recommendation

The Panel considered this Change Proposal at its meeting on 29 October 2019, where the Panel took three votes:

1. The Panel's first vote (8 in favour and 4 against) recommended the Proposed Solution with an implementation date of 1 January 2020. This vote was only on the implementation date and not on whether the solution should be recommended for implementation. It established the Panel's preference for 1 January 2020 over 1 April 2020 and therefore Panel preference for the Proposal over the Alternative.
2. The Panel's second vote (11 in favour and 1 against) recommended the solution of CPM018. This vote recommended a 1 January 2020 implementation date with 1 April 2020 as a fall back if Authority approval was not provided in time for a 1 January 2020 implementation.
3. The Panel's third vote (9 in favour, 1 against and 1 abstain from CCWater) recommended the additional drafting provided by MOSL to address an issue with working capital, with one Panel Member having left the meeting at this point.

In summary, the Panel recommended that the Authority approve the Proposed Solution. This recommendation was made on the basis of improving the principles of efficiency and non-discrimination. The recommended date of implementation is 1 January 2020.

We would like to highlight that following the Panel recommendation, we received a letter from Waterplus that provides information to support the views it raised during the industry consultation. Whilst we do not support information relating directly to a

Panel recommendation being sent to Ofwat outside of the formal code change process – and note this is the second time that a trading party has written to us following a Panel recommendation recently – for transparency we have shared this information with MOSL and the Panel.

Our decision

We have considered the Change Proposal and the supporting documentation provided in the Panel's Final Report. We have concluded that the implementation of the Proposed Solution of CPM018 will better facilitate the principles and objectives of the Market Arrangements Code detailed in Schedule 1, MAC Principles and Objectives, and is consistent with our statutory duties.

Reasons for our decision

Having reviewed the evidence provided by the Panel in its Final Report we understand the rationale for recommending this Change Proposal. We are therefore, approving the Proposed Solution with the expectation that the Panel, and MPC, continue to monitor and evaluate this approach of redistribution.

We agree that CPM018 seeks to address the issues we previously identified with the revised CPM008, namely Trading Parties having diluted incentives due to the redistribution of charges associated with MPS and OPS fines.

We recognise the concerns raised by some Trading Parties, specifically in relation to the transfer effect and also rewarding Trading Parties with low performance against MPS and OPS. In theory it would be possible to avoid dilution of incentives, avoid transfers between Trading Parties and avoid rewarding Trading Parties with low performance against MPS and OPS. This could be achieved by not redistributing any of the OPS and MPS fines back – for example by mandating upfront that all of the money be spent on projects to improve market functioning or by passing the charges to HM Treasury. But we agree with the analysis produced by Economic Insight for the MPC that this solution would not be in the best interests of business customers.

In general, we are satisfied that the MPC and Panel has given sufficient consideration to the question of non-redistribution, subject to the limitations associated with the current design of the MPF. We welcome the proposal that OPS and MPS fines could be spent on additional projects to enhance market functioning and benefit business customers. We are of the view that - in principle - it should not be difficult to identify additional projects that enhance market functioning and benefit business customers without conferring an advantage on individual Trading Parties. For example, there is still significant work to do in order to resolve market frictions so that the market can operate more effectively and better promote important innovations, such as improved water efficiency offerings. As a result, we do not agree with the assumption that funded projects would be infrequent. We suggest the process for project selection is kept under review – whilst we agree in principle with the proposed light touch approach, which includes transparent processes and reporting to ensure Panel accountability, this may need to evolve over time if projects that would genuinely improve market functioning and benefit customers are not being approved and funded. Similarly we suggest the selection criteria for special projects is kept under review to ensure market participants are actively encouraged to come forward with innovative, customer centric project ideas that will improve the functioning of the business retail market and that such projects are funded. Where money is redistributed to trading parties they may want to consider CCWater's suggestion of being transparent about how this money is spent to benefit customers.

We note the divergence of views from industry consultation responses on the appropriate implementation date. Of those that preferred a January 2020 implementation (6 Wholesalers and 4 Retailers), their rationale was that CPM018 would drive market improvements earlier. Respondents who preferred April 2020 (4 Wholesalers and 5 Retailers) cited their concerns around the business planning that had already been made for financial year 2019/20, and thus implementing in financial year 2020 would be less disruptive. On balance we believe earlier implementation would be in the best interests of customers and note the MPC's intention to prioritise OPS fines for project funding. We also acknowledge the perverse incentives and flaws associated with the current model of redistribution. This includes those identified by Economic Insight as well as the perverse incentive in relation to CPW072[2] that was highlighted by a retailer in response to the consultation.

We suggest the MPC regularly monitors and evaluates the impact of this redistribution solution as appropriate. We acknowledge that MOSL is leading work to reform the MPF to improve the effectiveness of the incentive framework to benefit business customers. In theory, the reformed MPF could result in a much smaller pot (or no pot) of charges to be redistributed to Trading Parties. For example, this could be the case if better defined and more effective incentives led to improved Trading Party performance or if fines were used to compensate Retailers or customers directly for poor levels of performance.

[2] CPW072 was approved by Ofwat on 1 November 2019 and removes the MPS 15 charges for a temporary period to act as an amnesty and incentivise retailers to submit old meter reads into CMOS. This is expected to improve the quality of market data. This incentive is reduced if the amount of money redistributed to companies is influenced by their performance against the MPS 15 standard.

We do have some concerns with the process undertaken to address the working capital issue raised by MOSL. This issue was raised by MOSL subsequent to the governance proposal for approving special projects being developed. The Panel was presented with options and subsequent legal drafting amendments at the Panel meeting and was asked to make a recommendation on these additions. The Panel noted the feedback from MOSL and agreed to restrict the award of project funding from 2019/20 and 2020/21 charges if MOSL had insufficient working capital. Going forward we expect all Change Proposals and their consequential impacts to be fully assessed prior to the Panel making its recommendation to us. We do not necessarily see the Proposed Solution to the working capital issue raised by MOSL as an enduring solution. However, we recognise that MOSL is considering alternative options for a longer-term solution and we agree with this approach. Further, we understand this issue will form part of a wider discussion with Trading Parties as part of MOSL's business planning and cash forecasting. We ask that an enduring solution be recommended to us, if appropriate, by the end of 2020.

We have set out below our views on which of the code principles are better facilitated by the Change Proposal.

Efficiency

We agree with the rationale provided by the MPC and Panel that this proposal should incentivise more efficient operation of the market by removing the dilution effects associated with the previous redistribution approaches, as well as encouraging special projects that will improve the functioning of the market and benefit customers.

Non-discrimination

We consider this Change Proposal to be non-discriminatory as the redistribution framework should ensure that access to special projects is available to all Retailers and Wholesalers. Furthermore funded projects will be expected to deliver broad-based benefits without conferring any significant competitive advantage to individual or small groups of Trading Parties.

Decision notice

In accordance with paragraph 7.2.8 of the Market Arrangements Code, Ofwat approves this change proposal.

Georgina Mills
Director, Business Retail Market