

Market Arrangements Code and Wholesale Retail Code Change Proposal – Ref CPM058a and CPW149a

Modification proposal	Market Arrangements Code and Wholesale Retail Code Change Proposal – Ref CPM058a and CPW149a – Market Performance Framework Reform (Governance)
Decision	The Authority has decided to approve this change proposal
Publication date	23 May 2024
Implementation date	26 June 2024

We are approving this Change Proposal.

This change is the first in a series of planned changes that are designed to reform the Market Performance Framework (**MPF**), the mechanisms designed to monitor, govern, and incentivise Trading Parties to deliver their obligations. CPM058a & CPW149a establishes new governance arrangements for the MPF, including the creation of a new Performance Assurance Committee (**PAC**) to replace the existing Market Performance Committee (**MPC**), a more flexible approach to reviewing the MPF, and clarification around MOSL being subject to external audits.

We are fully supportive of MPF reform and think that, designed appropriately, a reformed MPF could result in more effective incentives being placed on Trading Parties to drive improved market performance and better customer outcomes. We therefore welcome that this change establishes a framework to facilitate MPF reform. We think the governance arrangements proposed in this change are balanced and encourage a focus on the customer interest in MPF decision-making, particularly because of the composition of the PAC (which includes a significant independent/customer representative membership) and its quoracy and voting rules. We think a more agile approach to MPF reviews will enable them to be timely and targeted, improving their effectiveness. This could result in a more effective MPF which would benefit customers.

We recognise that much of the detail of MPF reform, including the PAC's remit, is still in development, and that the outcome of this work could influence our assessment of the appropriateness of the governance arrangements. If future MPF reform code changes

indicate a need to review the governance arrangements, we will pursue this without delay. Additionally, should we become aware that PAC meetings and decision-making do not facilitate the prioritisation of customer interests, we will take action to correct this.

Background

The Market Performance Framework (**MPF**) is a group of mechanisms that govern, monitor and incentivise Trading Parties to deliver their obligations under the market codes. The current MPF has been in place since the market opened and there is now a better understanding of its strengths and weaknesses, in particular – but not only – that it lacks a focus on customer outcomes. Consequently, the Strategic Panel asked MOSL to carry out a review of the MPF, which included multiple consultations and the development of a new approach.

In November 2023, MOSL published its [business case](#) for reforming the MPF, which was subsequently approved by the Strategic Panel. A change proposal to establish the programme of governance under which reform would take place, CPM058 and CPW149, was [accepted](#) by the Code Change Committee (**CCC**) in January 2024. It posited that different elements of reform would be delivered through a series of changes under CPM058 and CPW149 (a, b, c, etc.).

CPM058a & CPW149a represents the first element of reform and is concerned with the governance of the MPF.

Issue

All Trading Parties have to meet market performance standards and are therefore directly affected by the governance of MPF. Customer outcomes are also influenced by the way market performance standards are applied. It is therefore important that the MPF governance framework is effective. However, there are a number of issues with the current governance arrangements:

1) MPC membership is Trading Party-heavy and does not reflect expectations established from market governance review work

Ofwat's 2020 [Review of incumbent company support for effective markets \(RISE\)](#) argued that market governance could be improved to strengthen the customer voice, and suggested changing the composition of the Panel and its committees – for

example, by including a greater proportion of independent members, customer representatives, or experts – to achieve this. Following RISE, the Panel commissioned Satori Board Review to conduct an independent [effectiveness review](#) of the Panel, which suggested consideration be given to the composition of the Panel and its committees, including the balance of independents. In light of RISE and the Satori Board Review, changes were made to the market governance arrangements focusing on the Strategic Panel and CCC, which included ensuring both had a minority Trading Party membership.

Currently, Trading Parties make up nearly 80% of the MPC membership, with only the independent Chair (non-voting) and Customer Representative representing non-industry interests. The proportion of views representing customer interests and diverse experiences could be increased to represent a more balanced perspective on the committee.

2) There is a fixed framework to review market performance risks and develop the market performance workplan

Currently, the MPF is reviewed by MOSL with inputs from the Strategic Panel, MPC and Trading Parties on an annual basis via the market performance review. Although this takes place annually, historically changes to the MPF have been sporadic rather than annual.

The Change Proposal¹

CPM058a & CPW149a was proposed by MOSL. Its key change is that the MPC would be replaced by a new Performance Assurance Committee (**PAC**), which would take over all responsibilities previously held by the MPC. The composition of the PAC would differ to the MPC to place more emphasis on customer representative and independent perspectives. It would consist of:

- One independent (voting) Chair;
- Two independent members;
- One Customer Representative member from CCW; and
- Six industry representatives (three Wholesalers and three Retailers).

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>

At least the Chair, one Wholesaler member, one Retailer member, two non-industry members and a member of any type (six total) will be required for the PAC to be quorate.

The Strategic Panel expressed at its 1 March 2024 meeting a desire to ensure that only votes which had support from a non-industry member could pass. Therefore, where the Retailer and Wholesaler PAC members solely form the majority of votes, this will be considered a tie and the Chair will have the casting vote. This marks a change from the simple majority voting arrangement proposed in the third MPF consultation. It is proposed to create the PAC terms of reference, recruit and form the PAC before April 2025.

CPM058a and CPW149a also changes the approach to reviewing the market's performance. Currently, an annual Market Performance Report sets out the results of the implementation of the MPF in the previous year, while a Market Performance Operating Plan sets out the focus and priorities for the upcoming year. These reports are prepared by MOSL, the latter in collaboration with the Panel and MPC. Under CPM058a and CPW149a, three documents will be produced to track market performance:

- **Market Performance Review Report** – this provides a retrospective review of the MPF in the relevant period, and recommendations to modify existing, or introduce new, incentives. It is published by MOSL with input from the PAC at least every five years, or on request by the Strategic Panel.
- **Risk and Issues tracker** – this outlines key market risks and issues. It is produced by MOSL on an annual basis.
- **Statement of Approach** – this outlines the scale and use of market performance intervention tools for the following year. It is produced by MOSL with input from the PAC on an annual basis.

CPM058a & CPW149a also clarifies MOSL's auditing role in the market codes. Since April 2022, MOSL has conducted market audit functions in-house. This change sets out the role of a third party "Market Operator Auditor" to independently review whether the market operator has and is carrying out its obligations.

Impact

The Proposer has argued that CPM056 and CPW149a furthers the following Principles of the MAC and WRC:

Primary Principle – CPM058 & CPW149 seeks to ensure that the reformed MPF has proportionate incentives aimed at accountable Trading Parties, for Activities that are

explicitly tied to improved customer outcomes. CPM058a & CPW149a would allow customers to benefit from a PAC that makes decisions in their interests.

Continued development and sustainment of an effective market – CPM058 & CPW149 seeks to promote effective competition and reduce barriers to entry by reforming MPF. CPM058a & CPW149a would allow customers to benefit by having a PAC that starts from a clean slate and has a new way of decision-making.

Seamless NHH customer experience – By explicitly linking **Activities**, **Metrics** and **Tools** to customer outcomes, CPM058 & CPW149 will better incentivise Trading Party behaviour in relation to these, and therefore has a positive effect on customer experiences in the market. Although CPM058a & CPW149a does not deal with Activities, Metrics and Tools directly, it provides the governance framework for these to be operated.

Resilience – CPM058 & CPW149 will introduce new Activities that are specifically tailored towards incentivising water efficiency. Although CPM058a & CPW149a does not deal with Activities, it provides the governance framework for these to be operated.

Proportionality – CPM058 & CPW149 will introduce stretching targets and effective reputational and financial incentives, ensuring that high risk issues are treated with an appropriate sense of urgency, and ensuring Trading Parties face incentives effective enough to change their behaviour accordingly. Although CPM058a & CPW149a does not deal with targets and incentives, it provides the governance framework for these to be operated.

Efficiency – CPM058a & CPW149a contributes to the efficient, economic and effective administration and operation of the Competitive Market, by replacing a governance framework that is seen as ineffective at holding parties to account.

Industry engagement and assessment

Three consultations have been held for MPF reform. The most recent saw 27 responses comprising 14 Wholesalers, 11 Retailers, CCW and The Energy consortium. The following feedback from the consultation is relevant to CPM058a and CPW149a:

- At the time of consultation, it was proposed that the Chair of the PAC would be someone from MOSL. Three Trading Parties argued that an independent Chair would be more appropriate, including because there could be a conflict of interest between the PAC's responsibilities and MOSL's position. In light of this

feedback, the Proposer amended plans so that the proposal is now to have an independent Chair.

- At the time of consultation, it was proposed that there would be two Wholesaler members, two Retailer members, and six other members (two of which were non-voting).² Severn Trent proposed that three Wholesalers and three Retailers would be more useful to ensure the PAC has a good foundation of market understanding and a mix of Trading Party experience. The Proposer amended plans to reflect this suggestion.
- Water Plus, Thames Water and Business Stream expressed reservations with the move towards greater independent member representation, particularly due to the reduction in subject-matter expertise and increased operating costs. Business Stream suggested the PAC would benefit more from cross-Trading Party challenge than having an independent view. The Proposer pointed to Ofwat's recommendations for more independent members on committees, and said the cost of independent members is largely mitigated by fewer PAC meetings per year.
- Dŵr Cymru and water2business said there should be equal representation of small and large Trading Parties, and it was suggested small Trading Parties could be allowed to nominate a Spokesperson. The Proposer responded that all Trading Parties have equal opportunity to join the PAC, and PAC meetings being scheduled at least quarterly could encourage smaller Trading Parties to join PAC meetings.
- Three Wholesalers raised that there should be a minimum quoracy for each group of Trading Parties (i.e. Wholesalers and Retailers) to ensure decisions are made with the views of both sides. The Proposer implemented this suggestion, so at least one Wholesaler and one Retailer member must be present for the meeting to be quorate.
- Severn Trent argued monthly, rather than quarterly meetings, would be preferable to lead to faster rectification of issues. The Proposer responded that although regular PAC meetings will be scheduled quarterly, the PAC secretary will be able to convene additional meetings if required with at least 10 business days' notice.

Views of the Customer Representative

² At the time of consultation, the suggested composition of the PAC was one Chair from MOSL, two Wholesaler members, two Retailer members, a Customer Representative, two independent members, an Ofwat representative (non-voting) and a MOSL representative (non-voting).

The Consumer Council for Water's (**CCW's**) view on the change is provided in Attachment 2 of the CCC's Final Recommendation Report (**FRR**). Issues raised particularly related to this change included:

- It agreed with the four levels of governance proposed for MPF, of which the PAC is one level, as it is important to have a process that clearly distinguishes between operational and strategic decisions.
- It is important that performance is subject to periodic review as this aligned with the revised MPF being agile enough to respond to the changing priorities of customers and the market. However, it may be more appropriate to have fixed review periods as it may be undesirable for too much variance given the uncertainty around performance expectations that this may create. In addition, a constant revision of performance targets is unlikely to lead to sustained improvements, and therefore will leave customers worse off.
- It agreed in principle that the PAC, as a market led governance model, allows both trading party expertise, along with customer and independent voice, to guide decision making.
- It agreed with the need for the PAC as a "clean break" with the previous MPC.
- It agreed that the PAC should be subject to a market led style of governance. However, given the primary beneficiaries of an improved MPF will be customers, it is important they have equal representation with other parties.
- For the PAC to be effective, there needs to be a requirement of the PAC Chair to uphold the impartiality principle, and robustly challenge members on this where appropriate. In response to this point, MOSL said all PAC members are required to act in the interests of customers.

Code Change Committee (CCC) discussion and recommendation

The CCC considered this change at its 11 December 2023 meeting. It recommended, by majority decision (six votes in favour, three against) that Ofwat approves this change proposal.

Some members expressed concern that MPF governance was being approved before the detailed design of MPF metrics and tools had taken place and the PAC's remit were confirmed. They recognised that this was so that the programme could progress expeditiously, but it created the risk of MPF governance and the PAC's composition having to be revisited.

MOSL acknowledged that the detailed design of the metrics and tools were still being developed. However, the proposed MPF model in [Consultation 3](#) had received broad support from Trading Parties in October 2023 and its [business case](#) had been approved by the Strategic Panel in December 2023. Therefore, it said the remit of the PAC was clear and the detailed design of metrics and tools should not affect its composition.

The intention was to recruit the PAC over summer 2024 during the detailed design of metrics and tools.

The CCC noted that since consultation, the Strategic Panel had agreed to increase Trading Party representation on the PAC. This was in response to PAG and stakeholder feedback to broaden the PAC's industry experience. One committee member welcomed this, noting how Trading Parties' knowledge at the Market Performance Committee had been useful in resolving performance issues in the existing MPF.

A member noted consultation respondents' concern that seats were not designated to particular groups such as small Trading Parties. One member believed the best way to address this was to create more seats which would increase the opportunity for applicants from smaller Trading Parties or those less experienced in the market to be appointed. MOSL noted there was no guarantee who would apply to join the PAC but hoped fewer meetings than the current MPC would attract a broader range of applicants.

Several committee members were concerned that increasing Trading Party membership of the PAC would impact the industry/non-industry balance, noting that part of the rationale for MPF reform was to make decisions in the interests of customers. It was noted that while Trading Party members have good insight into the cause of market issues, having more lay members would ensure robust debate of issues affecting customer outcomes. One member stated that Trading Party expertise could be obtained by inviting experts to meetings, although voting would remain restricted to permanent PAC members. The committee heard MOSL's opinion that increasing lay membership to match the number of Trading Party members would incur additional cost and could present challenges in recruiting suitable independent or customer representative members. The committee noted that the proposed split was an improvement from the present MPC in terms of representation of independents.

A committee member asked how easy it would be to change the PAC membership and if flexibility could be included. MOSL explained that flexible membership had been considered. However, the PAC will make important market decisions, so it was proposed to codify the PAC composition to provide the market with assurance of the governance structure that will be in place.

Our decision and reasons for our decision

We have considered the issues raised by the Change Proposal and the supporting documentation provided in the FRR and have decided to approve the proposal. We have concluded that the implementation of CPM058a & CPW149a will better facilitate the principles and objectives of the Wholesale Retail Code and the Market Arrangements

Code (MAC) detailed in Schedule 1 Part 1 Objectives, Principles and Definitions, of the WRC and in Schedule 1 MAC, Principles and Definitions.

We think that MPF reform has potential to enhance and sharpen incentives on Retailers and Wholesalers to improve the performance of the market and ultimately customers' experience of it. We therefore welcome that this change initiates MPF reform, noting that this change will provide a framework for future change proposals.

We recognise that the creation of a new PAC allows a "clean break" with the previous MPC, facilitating a new approach to the MPF. Noting that one of the key goals of MPF reform is improving outcomes for customers, we think strong independent representation on the PAC will support this goal being met. As we found in our [May 2024 review of the market governance arrangements](#), increased independent and customer representative members of market governance committees can result in increased focus on, and prioritisation of, customer interests. Additionally, we think the quoracy and voting requirements will ensure that the customer voice is always considered in decision-making.

We note the view of some Trading Parties that the balance of the PAC is not Trading Party-heavy enough at the expense of expertise, and the views of some CCC members that further independent members, to equal Trading Party members, could be beneficial. Given the technical nature of MPF, we think Trading Party expertise is likely to be required. We think the proposed composition of the PAC in this change balances the need for this expertise with the need for independent views to be heard.

We think introducing increased flexibility to the market performance review framework will better align with how MPF changes are often introduced sporadically. We think this more agile approach will allow reviews to be more agile and better targeted, enhancing their effectiveness and thus supporting effective decision-making.

Like a number of CCC members, we recognise that the detail of MPF reform, including the PAC's remit, is yet to be finalised, but that this detail could have an impact on our view of the appropriateness of the MPF governance process. Therefore, while we are approving this change, if further MPF reform change proposals indicate an amendment to the governance arrangements is necessary, we will not hesitate to pursue this. Additionally, should we become aware that PAC meetings and decision-making do not facilitate the prioritisation of customer interests, we will take action to correct this.

Decision not to consult

Under Sections 66DB and 117G of the Water Industry Act, if Ofwat is minded to approve a change to the WRC, it is required to issue a statutory consultation on the change

unless it is assessed as being unnecessary to consult. We assessed that it was unnecessary to consult on this change for the following reason:

- **Does not significantly depart from the status quo** – CPM058a & CPW149a primarily establishes a new governance framework without making a change to the operation of the market. Adding increased flexibility to the review framework also does not represent a significant departure from the status quo.

Alignment with the Principles of the MAC and WRC

We agree that CPM058a & CPW149a will further the **Primary Principle** by establishing a governance framework under which MPF reform can take place, which has the potential to benefit customers through refining incentives on Retailers and Wholesalers to improve the performance of the market and thus the customer experience. Additionally, CPM058a & CPW149a establishes governance arrangements that emphasise independent and customer-representative voices in decision-making, which we think will enhance focus on customer interest in this context and reduce the risk that commercial interests are pursued at the expense of customer outcomes. We think a more agile review framework will enable more effective review of MPF measures, which will support the MPF in effectively working for the benefit of customers.

Additionally, we think this change will support the **continued development and sustainment of an effective market** by enabling MPF reform, which could result in more effective incentives being placed on Trading Parties to improve market performance. We think the change will also support the **efficiency** principle by replacing a governance framework that has been judged to be ineffective.

Decision notice

In accordance with paragraphs 7.2.9 of the Market Arrangements Code and S.66DC(1)(a) / S.117H (1)(a) of the Water Industry Act, the Authority approves this Change Proposal.

Dan Mason
Director, Business Retail Market