Market Arrangements Code Change Proposal – Ref CPM008

Modification proposal	CPM008: Redistribution of Market Performance Standards Charges
Decision	The Authority has decided to return this proposal to the Panel to revise and resubmit a Final Report
Publication date	8 May 2018
Implementation date	N/A

Background

The Market Performance Framework (MPF), as set out in Code Subsidiary Document 0002 (CSD0002), is intended to provide confidence to trading parties and the Market Operator that they and their peers are complying with their obligations; that risks to the Central Systems are being managed and that the performance of the market is being continually improved to ensure its orderly operation.

The MPF consists of a number of elements that monitor and report performance against a range of pre-defined standards and timescales. These standards are the Market Performance Standards (MPS) and the Operational Performance Standards (OPS). The MPS measure both retailer and wholesaler performance, whilst the OPS solely measure wholesaler performance. Peer comparison charts of the MPS and OPS are published on the MOSL website on a monthly and quarterly basis respectively. This reporting enables all trading parties to compare their performance with that of their peers.

From 1 April 2018, a charge is applied to a trading party for each individual failure against some of the MPS. Charges were suspended for the first year of operations to allow time for market participants and MOSL to ensure their processes were robust.

Under the terms of CSD0002, the Panel is required to review the MPS and OPS no later than nine months after go live. The Panel has elected to do this through creating the Market Performance Committee (MPC). The MPC is independently chaired and consists of four retailer members and four wholesaler members.

The MPC review has been of a limited scope due to:

- The time allowed within the code for conducting the review;
- At the time of the MPC review there was a lack of evidence available, due to only being 10 months into the market, to conduct a comprehensive review of the charging mechanism or to propose an alternative mechanism; and
- A number of defects affecting the reporting of MPS which limit the ability of the MPC to draw conclusions around market performance.

Following consultation, the MPC has put its proposal to the Panel who has recommended CPM008 (Redistribution of MPS charges) to the Authority for approval.

The issue

Where trading parties are required to pay charges for failing to meet OPS and MPS, a cash surplus will be accrued. The MAC currently provides for redistribution of this cash surplus in section 9.1.2:

> “If the Market Operator holds a surplus of Market Performance Standard Charges at the end of any Year, such surplus shall be redistributed to Undertaker Wholesale Businesses and Retailer Businesses in the same proportions as they shared the Market Operator Charges in that Year.”

According to the Panel recommendation report evidence indicates that retailers perform approximately 25,000 tasks per month which could incur an MPS charge, compared to the approximately 1,000 performed by wholesalers. As a result of the large difference in the quantity of tasks performed by wholesalers and retailers, retailers are contributing significantly more by way of MPS charges than wholesalers. The asymmetry in the level of charging between the retailer and wholesaler community is not reflected in the current method of redistribution. The Panel therefore believes that there is a risk that the funds are redistributed from retailers to wholesalers, essentially creating an extra cost to the retailer community which would likely be passed on to customers. As a result of the extra cost to the retailer community, the Panel also considers that retailers will subsidise wholesaler underperformance meaning there is less incentive on wholesalers.

We consider that the current method of redistribution does not effectively incentivise trading parties to perform against the MPS. Given the asymmetry in the level of charging there appear to be very poor incentives on wholesalers (who may end up receiving more via redistribution of surplus cash than the penalty charges they incur).

In addition, larger retailers face diluted incentives to perform well, since they may receive a large proportion of any penalties back in the form of redistributed funds.

The modification proposal[1]

Recommendation 12: MPS Charges levied on retailers and wholesalers should be ring-fenced

This change proposal suggests that wholesaler and retailer MPS charges should be ring-fenced for redistribution. Separation of the wholesaler and retailer charges into separate 'pots' will ensure that retailer charges are not transferred to wholesalers.

Industry consultation and assessment

The MPC issued a consultation on its proposed solution on 9 October 2017, 22 responses were received.

Question 12: Do you agree with the current mechanism for distribution of charges as set out in the MAC?

There was a mixed response to this question, out of the 22 respondents to this question, nine (three wholesalers and six retailers) did not agree with the current distribution of charges. Respondents suggested that the charges levied on retailers and wholesalers should be redistributed amongst retailers and wholesalers respectively. Responses also suggested that the charges should be used to fund industry-wide incentives and only any surplus should be redistributed.

Following consideration of consultation responses the MPC recommends that wholesaler and retailer charges should be ring-fenced into separate 'pots'. It noted the difference in the number of potentially chargeable tasks performed by retailers and wholesalers with retailers performing significantly more. The current mechanism for redistribution within the MAC results in wholesalers as a group receiving 50% of total charges, and the Panel believes that the overall effect of this is that wholesalers will receive an inappropriate benefit at a cost to the retailer community.

[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

A further consultation, which closed on 19 January 2018, was undertaken by the MPC in order to further refine its recommendation.

15 of the 23 respondents (eight retailers and seven wholesalers) to the second consultation supported the MPC's proposal with regard to ring-fencing MPS charges for redistribution purposes. However, there were two key themes of feedback provided from trading parties who disagreed with the MPC's proposal:

1. Three retailers and three wholesalers suggested that the funds should be used to fund innovation projects which would benefit the industry rather than being redistributed amongst trading parties. The MPC has committed to giving thought to this suggestion in the future.
2. There was concern expressed by one wholesaler that lower performing trading parties could still see a large proportion of its charges returned to them. The MPC considered this concern and concluded that the operation of the ring-fencing method for distribution will result in rewarding good performance at the expense of poor performers in each of the two classes, wholesaler and retailer.

Panel recommendation

At the Panel meeting on 27 February 2018, the Panel determined by unanimous decision to recommend CPM008 to the Authority for implementation on the basis of improving the principles of efficiency and proportionality.

Our decision

We have carefully considered the issues raised by the modification proposal and the supporting documentation provided in the Panel's recommendation report.

We have decided to return this proposal to the Panel for further consideration. We believe that the proposal is likely to result in weak incentives for good performance from larger retailers and wholesalers – these aspects have not been fully considered in the Panel's assessment. We have therefore been unable come to the view that the proposed modification better furthers the principles and objectives of the Wholesale Retail Code, detailed in Schedule 1 Part 1 Objectives, Principles and Definitions. We consider that further work is needed to either improve upon the proposal or identify an alternative appropriate method for dealing with Market Operator credited charges. We request that the Panel reviews this recommendation and resubmits a Final Report as soon as practicable.

Reasons for our decision

We are aware that there are weaknesses in the current method of redistribution of charges provided for in section 9.1.2 of the MAC. Of particular note from the Panel recommendation is that wholesalers perform significantly fewer tasks than retailers and are therefore exposed to, and will ultimately pay, significantly less MPS charges than their retailer counterparts. The incentive for wholesalers to perform well is therefore reduced as they would receive a larger payment from the annual redistribution of charges than the fees they would have incurred during the year. We do not consider that the current method for redistribution appropriately incentivises trading parties.

The Panel recommendation report suggests that the change proposal better furthers the principle of efficiency as it sharpens the incentives on trading parties and therefore, improves the efficiency by which wholesalers and retailers are encouraged by and deliver the standards. The Panel report also suggests that the proposal better furthers the principle of proportionality as it ensures the redistribution of charges is more proportionate in relation to contribution. The proposal seeks to reflect the difference in the number of tasks completed, and therefore charges paid, by the two classes of trading party.

We do not believe that the evidence presented along with this proposal is sufficient to demonstrate that the principles of efficiency and proportionality have been furthered, for the reasons detailed below.

We consider that approving the change proposal presented to us would result in dilution of the incentive effect. This is because trading parties, particularly larger wholesalers and retailers, who perform poorly under the proposed model for redistribution would still benefit from the redistribution of a large proportion of the charges paid – effectively diluting the deterrent effect of the charges.

Equally, where performance is poor from all trading parties the charges paid by each trading party would be returned directly to them, meaning there would be no financial incentive to achieve a high level of performance. Whilst it is noted that this change proposal positively improves incentives on wholesalers to some extent (i.e. removes the risk that they could receive more from redistributed cash surplus than they pay out in penalties), we consider that implementation could ultimately lead to consumer detriment because the incentive for large retailers and wholesalers to perform well is diluted.

The dilution problem is illustrated with reference to retailers in the examples below, but could equally apply to wholesalers.

Example 1

	Invoice Level	Market share	Tasks	% tasks on time	Uncapped Charges	Capped charges	Redistributed element	% redistributed	Net Charges levied
Retailer 1	£50,000,000	45.25%	62500	40	£687,500	£75,000	£75,000	100.00%	£0.00
Retailer 2	£50,000,000	45.25%	62500	40	£687,500	£75,000	£75,000	100.00%	£0.00
Retailer 3	£5,000,000	4.52%	6250	40	£68,750	£7,500	£7,500	100.00%	£0.00
Retailer 4	£5,000,000	4.52%	6250	40	£68,750	£7,500	£7,500	100.00%	£0.00
Retailer 5	£500,000	0.45%	625	40	£6,875	£750	£750	100.00%	£0.00

In this example, all retailers are performing very poorly – only 40% of tasks are completed on time. However, because performance is equally poor across all retailers, each retailer gets 100% of their charges back. So there is no penalty at all for very poor performance. We would not expect trading parties who are failing to perform well to avoid a penalty by any proposed method.

Example 2

	Invoice Level	Market share	Tasks	% tasks on time	Uncapped Charges	Capped charges	Redistributed element	% redistributed	Net Charges levied
Retailer 1	£50,000,000	45.25%	62500	90	£62,500	£62,500	£68,778	110.05%	-£6,278.28
Retailer 2	£50,000,000	45.25%	62500	40	£687,500	£75,000	£68,778	91.70%	£6,221.72
Retailer 3	£5,000,000	4.52%	6250	90	£6,250	£6,250	£6,878	110.05%	-£627.83
Retailer 4	£5,000,000	4.52%	6250	40	£68,750	£7,500	£6,878	91.70%	£622.17
Retailer 5	£500,000	0.45%	625	40	£6,875	£750	£688	91.70%	£62.22

In example 2, the performance of retailers 1 and 3 has improved dramatically. Whilst this means there is now a financial difference between performers, those retailers who have very low levels of performance still get 92% of their charges returned to them – significantly diluting the impact and effectiveness of the penalties. We are concerned that, under the current proposal, trading parties are not suitably incentivised by the MPS.

It is noted that the second consultation elicited responses such as using Market Operator credited charges to fund innovation projects of benefit to the industry. Within its recommendation report, the Panel highlighted that there might be merit in using the charges to fund innovation projects which may save customers money in the long term, as opposed to redistributing these amongst trading parties and committed to considering it as part of its future work. The Panel may wish to take the opportunity to consider this further at the present time given that we have been unable to form an opinion on the present change proposal.

It is noted that the decision to return this change proposal to the Panel may result in uncertainty for trading parties in the short-term. Trading parties should however continue to be incentivised to perform well against the MPS during the development of a new proposal. Whilst MPS charges are currently being incurred and paid by trading parties, the MAC provides for annual redistribution of these charges. Therefore, section 9.2.1 of the MAC is not due to be employed until April 2019, and we expect that a suitable proposal should have been raised and approved by the Authority well in advance of this date.

We encourage the Panel to expedite its review of this proposal and submit a Final Report to us as soon as practicable, given the potential impact on trading parties and in particular on end customers. In turn, we commit to making a decision on a revised proposal as quickly as practicable once we receive a recommendation from the Panel.

Decision notice

In accordance with section 7.2.7 of the MAC, we have determined that we cannot properly form an opinion on this change proposal. We request that the Panel reviews alternative options for recommendation and resubmits a revised Final Report as soon as is practicable for our consideration.

Emma Kelso
Senior Director, Customers and Casework