# Market Arrangements Code Change Proposal – Ref: Revised CPM008

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| **Modification proposal** | Market Arrangements Code Change Proposal - Revised CPM008: Redistribution of Market Performance Standard (MPS) Charges |
| **Decision** | The Authority has decided to approve this change proposal |
| **Publication date** | 4th February 2019 |
| **Implementation date** | 29th March 2019 |

# Background

As part of its review of Market Performance Standards (MPS) and Operational Performance Standards (OPS) undertaken as part of its review of the Market Performance Framework (MPF), in March 2018 the Panel put forward its original final recommendation report CPM008 ('Original CPM008'). That proposal set out the Panel's proposed changes to the way in which financial penalties, payable by retailers and wholesalers where they fail to meet their MPS obligations, would be redistributed in the years 2018/19 and beyond.

Ofwat, in May 2018, published a decision document[1] which returned the proposal to the Panel for further consideration and requested that the Panel review alternative options for recommendation and resubmit a revised Final Report. The proposal was returned because at that time insufficient evidence was presented to demonstrate that the principles of efficiency and proportionality had been furthered and that in particular, we considered that the proposal as presented was likely to result in weak incentives for good performance by trading parties.

The Panel pursues these matters through a subsidiary committee, the Market Performance Committee (MPC). The MPC is independently chaired and comprises industry representation from four retailer and four wholesaler members. The Panel referred Ofwat's decision and request to the MPC for further consideration and review.

In October 2018, following consultation, the MPC put forward its revised proposal to the Panel, which in November 2018 issued its final recommendation report Revised CPM008 Redistribution of Market Performance Standard (MPS) charges ('Revised CPM008') to Ofwat for approval.

[1] Ofwat May 2018 https://www.ofwat.gov.uk/wp-content/uploads/2018/05/Market-Arrangements-Code-Change-Proposal-ref-CPM008.pdf

# The issue

As set out in our May 2018 decision document, where trading parties are required to pay charges for failing to meet MPS standards, a cash surplus will accrue. The Market Arrangements Code ('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."

As set out in our May 2018 decision document, we consider that the current method of redistribution does not effectively incentivise trading parties to perform against the MPS.

# The modification proposal

### Recommendation

The Panel's change proposal Revised CPM008 recommends MPS charges are ring-fenced for redistribution and redistributed in years 2018/19 and 2019/20 as follows.

<u>Year 2018/19</u>

An interim solution is adopted, with two key elements:

(1) MPS charges for retailers and wholesalers to be treated independently – so any cash surplus accruing from retailers' payment of MPS charges will go to a retailer 'pot' to be redistributed only to retailers, and similarly for wholesalers.

(2) Each MPS 'pot' would be redistributed as follows:

    50% to be allocated in accordance with the Original CPM008 proposal;

    50% to be allocated in accordance with the proposal for the method of allocation for Year 2019/20, as summarised below.

Year 2019/20

MPS charges are redistributed as follows:

(1) As for 2018/19, MPS charges for retailers and wholesalers to be treated independently, with the creation of separate retailer and wholesaler charging 'pots'.

(2) Each MPS charging 'pot' would be redistributed according to an algorithm which is 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 trading parties ('Approach 4').

## Industry consultation and assessment

Following Ofwat's May 2018 decision, the MPC developed its view and what it was minded to propose in response. Between 7 and 21 September 2018[2], it consulted with trading parties on what it was minded to propose. 25 trading parties (12 wholesalers and 13 retailers) responded to the consultation.

Responses highlighted three factors which are relevant to how Ofwat assessed the Panel's modification proposal:

### i) Separate distribution of wholesaler / retailer MPS charges

All the retailers and 8 of the wholesalers who responded agreed to the separation of the charging 'pots'. The Panel noted that one respondent "suggested that the disparity in the volume of tasks would make a single pot redistribution inequitable" and that another "advised that a separation of charging pots is required as Wholesalers and Retailers do not undertake the same tasks and are not charged on a 'like-for-like' basis."

Of the wholesalers who disagreed, the Panel noted that one said that "separating the charging pots is a financial change and should therefore not be done before the end of the financial year" and another "suggested that charging pots will not be necessary if non-redistribution is agreed."

[2] Panel paper - Referral of CPM008 – Redistribution of Market Performance Standard Charges V1.0 7th September 2018. Paper and supporting documents available here: https://www.mosl.co.uk/download-document/9f04581f7a457e861a12019309a04c15

### ii) Redistribution of MPS charges

Most retailers (12 out of 13) did not support non-redistribution, while wholesalers' reactions were more mixed, with just under half (5 out of 12) stating that they did not support non-redistribution.

The Panel noted that many respondents did not support non-redistribution because "the framework for Market Performance Charges has always included a redistribution of MPS Charges at the end of the financial year. This redistribution was assumed whilst business plans were developed for the financial year. Removal of this mechanism now for the 2018/19 year could be considered retrospective regulation by Ofwat." The Panel also noted that one respondent "suggested that redistributing the funds will result in a greater benefit to the end-customer, rather than retaining them for a central purpose."

Concerning those respondents that did support non-redistribution, the Panel noted that one "advised that redistribution of MPS Charges weakens the incentive properties of the charging framework" and that another "added that by not redistributing performance charges, the charges could be used for alternative market-wide solutions."

### iii) Question of performance based metrics and potential approaches

There was significant in-principle support for the use of performance based metrics to determine redistribution, including that most respondents said they:

- supported the use of performance based metric to determine redistribution (23 out of 25);
- agreed that the present metric (percentage of on-time of tasks) is the acceptable metric to use to determine performance (23 out of 25); and
- supported the principles associated with 'Approach 4' for redistribution (22 out of 25).

Some trading parties who set out their support as above nevertheless expressed some reservations or highlighted the need to be cautious, including for example views that not all MPS activities require the same level of effort, and that the 'banding' under Approach 4 could have some unintended consequences such as some perverse incentives to perform at a lower level within a particular band.

Of those setting out their disagreement with one or more of the above elements, the Panel noted that one trading party suggested that use of the percentage of on-time tasks as a performance metric "could drive a behavioural pattern that 'average performance is acceptable". Furthermore, regarding Approach 4, the Panel noted that one trading party remarked that "whilst [A]pproach 4 will give an incentive to outperform peers, it still does not provide a clear framework of what 'good' performance should be and what should be rewarded as good".

## Panel recommendation

At the Panel meeting of 30 October 2018, the Panel determined by a majority decision to recommend Revised CPM008 to the Authority for approval.

## 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 significant reservations concerning the extent to which the Panel's Revised CPM008 demonstrates adequately how the proposals for redistribution of MPS penalties support or improve the principles of efficiency and proportionality on an enduring basis. These concern two aspects in particular:

- **Diluted incentives:** The Revised CPM008 proposals may for example result in a trading party paying no net charges where their performance does not, in absolute terms, meet industry requirements (i.e. is poor), provided such performance is better than performance by other trading parties.

  We find it difficult to reconcile such diluted incentives against the need to ensure that end customers, as well as effective market functioning, are well served by good performance – in absolute terms - of those in the market. They will be best served where, among other things, trading parties who fail to meet required standards face appropriate financial penalties.

- **Non-redistribution:** The MPC and Panel has in our view given insufficient consideration and provided insufficient evidence to the question of non-redistribution, which may be a method for avoiding undue dilution of incentives under the MPS regime.

Nevertheless, we recognise that the Revised CPM008 proposal represents an improvement against the Panel's Original CPM008, in particular because:

- The proposed redistribution of charges, to wholesalers and retailers separately, ensures that those who perform best are rewarded with a net receipt of monies, while those who perform worst receive no redistribution of monies and so are likely to face a net financial penalty for (relative) poor performance.

- Rewarding relative performance in this way may create some incentives over time for each trading party to increase their absolute performance, as they seek to avoid the risk of incurring net financial penalties on the basis of poor relative performance.

We have therefore decided to approve the Panel's Revised CPM008 proposals, but expect the MPC and Panel to note the following points:

- We consider that the proposal represents a transitional arrangement only, pending further development by the Panel or MPC of proposals for an enduring solution to apply from 2020/21 onwards and we expect a firm commitment from the Panel and MPC in this regard;

- The Panel should  issue a Final Report to Ofwat consisting of proposal(s) for such an enduring solution no later than Friday 25th October 2019[3]; and

- Proposal(s) for such an enduring solution should address weaknesses in Revised CPM008, particularly concerning diluted incentives, and the potential for non-redistribution of charges to contribute significantly to obviate such diluted incentives.

We expect the Panel and MPC to take these points into account when considering its proposals for an enduring solution concerning MPS charges. When we receive the Panel's recommendation for such an enduring proposal in October 2019, if we consider that the Panel and MPC has failed to adequately take these factors into account, then we are likely to propose an Authority Timetabled Change Proposal.

## Reasons for our decision

As set out in our May 2018 decision document, 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.

We noted that Original CPM008 would have resulted in poor incentives on parties to improve performance against MPS standards, and highlighted in particular two effects:

- **Dilution of the incentive effect**

  Poor incentives result from the fact that trading parties, particularly larger wholesalers and retailers, who perform poorly under the proposed model for

[3] This should give Panel ample time to assess a full year of performance data for 2018/19.

redistribution would still benefit from the redistribution of a large proportion of the charges paid – effectively diluting the deterrent effect of the charges.

- **Poor incentives where all parties perform equally poorly**

  Poor incentives arise because where all trading parties perform poorly the charges paid by each party would be returned directly to them, meaning there would be no financial incentive to achieve a high level of performance.

We also noted that within Original CPM008 the Panel highlighted that there may 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. Our May 2018 decision document invited the Panel to consider this 'non-redistribution' option further.

We consider that the Panel's Revised CPM008 does not fully address our concerns, and insufficiently considers the merits of a 'non-distribution' option.

Furthermore, we note that Revised CPM008 recommends that redistribution for 2018/19 should comprise 50% of the Original CPM008 proposal and 50% of proposals for 2019/20 as set out in Revised CPM008. Given that we have already returned the Original CPM008 proposals to the Panel on the basis that it effectively dilutes the deterrent effect of the charges[4], we confine comments here to the merits of the proposals for 2019/20. In particular we comment as follows:

- **Dilution of the incentive effect**

  The proposal for 2019/20 rewards relative performance by tilting the re-distribution of penalties to those who perform best. Those who perform worst in relative terms do not receive monies back. In circumstances where all parties perform poorly in absolute terms, the best performers among them receive more money back than they pay in.

  This means that the redistribution effect risks rewarding trading parties even where their performance is, in absolute terms poor, but where their performance is better relative to other trading parties. Whilst not as egregious a dilution effect as under the Original CPM008 proposals, we nevertheless consider this to be a form of dilution of the deterrent effect of the charges.

- **Consideration of non-redistribution option**

[4] For our reasoning regarding our return of the Original CPM008 proposals to the Panel, including the dilution of the deterrent effect, see Ofwat Decision May 2018, pp.4-5 https://www.ofwat.gov.uk/wp-content/uploads/2018/05/Market-Arrangements-Code-Change-Proposal-ref-CPM008.pdf

The Panel has set out its consideration of the non-redistribution option (§3.4). Whilst the Panel recognises the merits of this option, it nevertheless set out arguments that they are outweighed at the present time by a number of weaknesses. In our view these arguments are insufficiently developed, in particular we comment as follows:

- **Cost pass through to customers**

  To the extent trading parties incur net costs associated with poor performance against MPS standards, we agree that these will form part of the relevant trading parties' operating costs.

  However, we disagree that such charges will necessarily always be passed through to or always result in higher charges for customers. This is for three reasons:

  - MPS charges are designed to incentivise trading parties to improve performance. To the extent that trading parties perform in ways consistent with underpinning efficient market operation, no MPS charges will be levied;

  - Retailers who incur MPS charges will find themselves at a competitive disadvantage and, rather than passing through costs to customers, would instead be more likely to lose market share;

  - Wholesalers are not permitted to pass on such costs to customers under the terms of the price controls applying to them.

- **Use of the 'pot'**

  The Panel have put forward little discussion of how the challenges of using the 'pot' could be overcome. For example the Panel have set out little discussion of:

  - what learnings could be taken from elsewhere or other industries concerning the potential operation, for example concerning appropriate governance arrangements, under a non-redistribution option.

  - whether (any) tax implications of use of the 'pot' under a non-redistribution option would actually arise or how any tax issue here could be overcome.

- **Trading parties' reasonable expectations**

  The Panel have described how trading parties have indicated that they have an expectation that monies would be redistributed in 2018/19. The Panel also noted that it is aware of the risks of legal challenge were a retrospective change to the concept of full redistribution to be made.

  The Panel also set out that the "MPC intends to review redistribution as part of the annual MPS review and does not rule out a move to a non-redistribution after two full years of MPS charging".

  Whilst we note that it would be inappropriate to revise retrospectively arrangements that are already in place, we consider that the proposals are insufficiently developed concerning any question of a transition or commitment to a non-redistribution arrangement, which could for example re-set legitimate expectations for the future as well as consider non-redistribution as a holistic part of incentive arrangements best oriented to meet the principles of efficiency and proportionality.

  Furthermore, we would expect trading parties, in forming their reasonable expectations about any re-distribution, to give primary regard to the need to meet MPS standards rather than, for example, plan on the basis that any financial penalties for any shortfalls in performance may be offset by redistributed revenues.

# Decision notice

In accordance with section 7.2.8 of the MAC, the Authority approves this change proposal.

**Emma Kelso**
**Senior Director, Customers and Casework**