
Market Arrangements Code Change Proposal – Ref CPM044

Modification proposal	Market Arrangements Code Change Proposal – CPM044 – Management of the Ofwat Innovation Fund
Decision	The Authority has decided to approve this Change Proposal
Publication date	09 November 2021
Implementation date	17 November 2021

Background

The 2019 price review allowed revenue to be collected by Wholesalers¹ to contribute to a £200m fund to drive innovative initiatives in the water and wastewater sector that go beyond business as usual and deliver tangible benefit for customers, society and the environment across England and Wales.

The Authority has run two Innovation Fund challenges to date (the 'Innovation in Water Challenge' and the 'Water Breakthrough Challenge 1') with winners receiving a proportion of the Innovation Fund. For the Innovation in Water Challenge, the Authority calculated the settlement between contributing Wholesalers and winning projects, and then each contributing Wholesaler transferred their proportion of the Innovation Fund to the winning project lead.

The next challenge round has just opened, the Water Breakthrough Challenge 2, and it is the Authority's intention to run further Innovation Fund challenges throughout this price review period (2020–2025).

The issue

The current administration of the settlement means that each contributing Wholesaler has to set up and make payments to multiple payees each time a challenge is run. Each winning project lead has to collect the Innovation Funds from the 17 contributing Wholesalers. This is inefficient and time-consuming and provides scope for miscommunication due to the number of parties involved.

¹ Unless otherwise specified, the terms used in this document are those defined in the Market Arrangements Code (MAC) as approved by this document

As a result, the payment of monies to the winner(s) of the relevant challenge are at risk of delay meaning that the subsequent realisation of any benefits by customers, society or the environment may also be delayed.

The Change Proposal²

This change proposes that the Market Operator (MOSL) may be permitted to manage and administer the transfer of monies to and from Wholesalers and winning project leads for the life of the Innovation Fund, i.e., for each challenge.

The extension of the Market Operator's role for this purpose will be fully funded by Wholesalers through their Innovation Fund allowances and will not result in an increase in Market Operator Charges.

Industry consultation and assessment

A consultation on proposal CPM044 was carried out by MOSL between 8 September and 29 September 2021. There were 17 responses from 10 Wholesalers, 6 Retailers and the Consumer Council for Water (CCW).

Revised Market Operator Function

Fourteen respondents strongly supported the proposal and agreed that the Market Operator is suitable to administer the Innovation Fund, whilst three respondents disagreed with the proposal.

Those supporting the proposal highlighted the Market Operator's expertise, knowledge and resources that make it suitable for the role. Respondents highlighted that it is a reliable, well-trusted body with the resources and experience to perform the function efficiently. Respondents considered that improved efficiency in the administration and operation of the Innovation Fund should translate to wider benefits to customers received from delivering innovation as well as benefits to smaller Wholesalers in particular by reference to a reduced administrative burden.

A small minority of respondents noted that whilst the Market Operator has the capability to perform this function and may be suitable to do so, the administration of the Innovation Fund should sit outside of the market and its codes as the Market Operator is funded by members to administer the retail market, and instead changes should be made to MOSL's Articles of Association to accommodate this revised function as a matter for consideration by MOSL's Board. One respondent raised a concern that this change proposal would set a precedent to extend the Market Operator's role and mission. In addition, there were also concerns raised about the Market Operator being appropriately indemnified to carry out this function, the impact on the retail market of

² The proposal and accompanying documentation is available on the MOSL website at <https://www.mosl.co.uk/market-codes/change#scroll-track-a-change>

the Market Operator diverting its resources to administer the Innovation Fund and whether this would bring any benefits to the retail market and to Non-Household Customers.

New MAC Principle

A question was raised about whether the addition of a new principle to support the Market Operator's newly introduced function was appropriate or necessary, primarily due to the reference to the 'UK water and sewerage market', and if this could extend outside of the Market Operator's and Authority's geographical area. It was noted that the MAC already has a principle on innovation under Principle: Continued development and sustainment of an effective market (section 1.3 of Schedule 1).

Preferred supplier

Some respondents asked how the Market Operator had been identified as the preferred supplier for the administration of the Innovation Fund.

MOSL Board requirements

The MOSL Board was asked for its view on the change proposal because it would be permitting MOSL to take on a new function as the Market Operator. The MOSL Board indicated that it will support the new function provided that:

1. MOSL is fully indemnified to perform the new function so that no liability is incurred by it or its Members; and
2. The Authority must consider widening participation to the Innovation Fund challenges so that Retailers may submit bids directly without the need for a Wholesaler sponsor.

In working with MOSL to develop this change proposal, the Authority has considered the need for MOSL to be indemnified, and this is reflected in the MAC amendments and the contract that MOSL and contributing Wholesalers will enter into prior to funds being transferred.

With respect to the MOSL's Board requirement that direct access for Retailers be considered the Authority has confirmed that it intends to review our current innovation fund policies towards the end of the pilot period which ends in March 2022. We will continue to work with stakeholders and third parties to design any changes to the competition which will be implemented for years 3-5 of the Innovation Fund. As part of that we will keep the eligibility under review, including by actively considering the opportunities, benefits and options for Retailers to have access to the fund independently.

Panel recommendation

The Panel considered this Change Proposal at its meeting on 26 October 2021. It recommended, by majority decision (11 in favour, 1 against and 1 abstention), that the Authority approve this proposal. This recommendation has been made on the basis of improving the Primary Principle and the Supporting Principles of Transparency and

Clarity and To Support Innovation. The recommended date of implementation is 17 November 2021.

Several Panel Members indicated that although they were supportive of the Innovation Fund and its intentions, they did not believe that the administration of the Innovation Fund should be a role carried out by the Market Operator. One Panel Member, who voted against the change, indicated that it may be suitable for MOSL specifically, but not the Market Operator more generally. Two Panel Members queried if it would be more appropriate to include this option in MOSL's Articles of Association, rather than the MAC which would mean that this function would forever be built into the role of the Market Operator. The Market Operator responded to this query by confirming that including this option within the MAC was a smaller change than amending MOSL's Articles of Association.

One Panel Member, who abstained from voting, raised concerns about procurement risks and whether Wholesalers would provide the indemnity to the Market Operator should it carry out the service. The Market Operator confirmed that it would not be involved in any procurement process or assessment of bids to the Innovation Fund. In addition, the drafting within the MAC and the commercial contract contributing Wholesaler's will be required to enter to enable this function to go ahead include indemnity clauses.

It was unclear to another Panel Member how the improvement of the Innovation Fund's administrative efficiency would benefit winning projects and customers. The Authority confirmed that for the Innovation in Water Challenge it has taken four to five Months to move money. Under this option, the lead time is one Month. Concerns raised about an increase to MOSL's resource costs, especially if the Innovation Fund increases in complexity, were allayed after MOSL confirmed that costs would not be material, the tasks required of it could be easily managed and costs would be covered by the contributing Wholesalers.

Our decision and reasons for our decision

We have considered the issues raised by the Change Proposal and the supporting documentation provided in the Panel's Final Report and have decided to approve the proposal. We have concluded that the implementation of CPM044 will better facilitate the principles and objectives of the MAC detailed in Schedule 1 MAC, Principles and Definitions, and is consistent with our statutory duties.

We welcome the support Panel Members offered to the Innovation Fund and its objectives, as well as the strong support from the majority of the respondents to the consultation.

We note the concerns raised in response to the consultation that this work could draw the Market Operator away from its core functions, and the query raised about whether this function would bring benefits to the retail market and to Non-Household Customers. We consider that this change will facilitate the **Primary Principle** by seeking to protect and promote the interests of all water sector customers, including Non-Household Customers, by better enabling the administration of the Innovation Fund and thereby allowing innovative projects (which could benefit Non-Household Customers) to get up and running within the timescales that have been proposed.

In developing this change proposal with MOSL, we have worked to ensure that the Market Operator's core functions and the operation of the retail market will remain unaffected by it. We note a respondent's concern that this change could set a precedent to extend the Market Operator's role and mission. As detailed in the Final Report, MOSL has indicated that, after setup, there will be a minimal annual resource cost of approximately 26 hours a year, for which it will be reimbursed from the Innovation Fund. The Authority confirms that this change proposal does extend the Market Operator's role but agrees with respondents to the consultation that there is a significant resource saving for the sector which has particular benefits for those taking part in the challenges – which includes Wholesalers and Retailers – through the efficient transfer of funding to enable projects to start on time which are designed to bring wider benefits for customers (including Non-Household Customers), society and the environment across England and Wales. The Authority is sympathetic to the concerns around role creep. In approving this modification it relies on the fact that the new activities within the scope of this principle must have the Authority's consent.

We consider that the change furthers the supporting principle of **Transparency and Clarity** by ensuring that the transparency of the MAC remains consistent following this change with it being accommodated in separate parts of the MAC thereby ensuring the accessibility of the MAC to both existing and prospective Trading Parties and that this change does not detract from the normal operation of the market. We note the concerns raised by Panel Members about the suitability of using the MAC as the vehicle for enabling MOSL to offer this administrative service to the Innovation Fund. We agree with MOSL's view that this is a simpler change than to MOSL's Articles of Association. It is also significant that this change permits but does not require MOSL to assist contributing Wholesalers to the Authority's Innovation Fund by administering the settlement process. It does not appoint MOSL as that administrator – this is for MOSL and contributing Wholesalers to agree.

We note queries raised by respondents to the consultation and Panel Members regarding the implementation of a new principle, especially shortly after their re-

design. We have decided that a new supporting principle to the MAC³, '**To Enable Innovation**' is essential for the proper operation of the new function⁴ of the Market Operator. We do not consider that the existing supporting principle within the MAC that deals with innovation (Continued development and sustainment of an effective market) is broad enough to encompass this new function. In addition, there is a need for a tightly drafted new supporting principle within the MAC to scope out this new function to ensure that the Market Operator's core function and any extension to it is protected by clear governance.

In response to the questions about indemnity and procurement raised by a Panel Member and respondents to the consultation, we consider that the proposed drafting amendments to the MAC sufficiently set out how the Market Operator will be indemnified by contributing Wholesalers, including by reference to a binding commercial contract that will be entered into by contributing Wholesalers and MOSL. As detailed in the Final Report, the Market Operator is considered the preferred supplier for this service because of its pre-existing relationship with Trading Parties and experience of handling settlement payments within the water industry. In addition, research conducted by the Authority in respect of alternative options indicated that it offered the best value for money for this service. But in any event, these changes only provide a permission for MOSL to fulfil this role. They do not confer the role on MOSL. This is for MOSL and Wholesalers to agree separately.

Decision notice

In accordance with paragraph 7.2.9 of the Market Arrangements Code, the Authority approves this Change Proposal.

Georgina Mills
Director, Business Retail Market

³ The new function of the Market Operator cannot be contained within the Wholesale Retail Code because it is not within its statutory scope.

⁴ As included at new section 3.1.3 of the MAC