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ENERGY RETAIL Association

28 February 2012

Dear Ms Forbes

Ofgem's Draft Enforcement Guidelines on Complaints and Investigations

The Energy Retail Association (ERA), formed in 2003, represents electricity and gas suppliers in the domestic market in Great Britain. All the main energy suppliers operating in the residential market in Great Britain are members of the association - British Gas, EDF Energy, npower, E.ON, ScottishPower, and SSE.

The ERA welcomes the opportunity to respond to Ofgem's consultation on its Draft Enforcement Guidelines on Complaints and Investigations. This is a high level industry view and the ERA's members will also be providing individual responses. We would be happy to discuss any of the points made below in further detail with Ofgem if this is considered to be beneficial.

Summary

The ERA warmly welcomes Ofgem's wholesale review of its approach to enforcement. We believe that this is particularly important given the Retail Market Review (RMR) and proposed shift towards principles-based regulations (PBRs) through the Standards of Conduct (SOCs). Indeed, since the way in which companies respond to regulation is in part shaped by the way in which it will be enforced, we do not consider that it is possible to understand what the effect of any SOCs will be until the way in which they might be enforced is determined. It would therefore be reasonable to conclude that the SOC proposals are as yet incomplete, and the enforcement review is a vital piece of the puzzle. In this regard, we would ask Ofgem to treat the ERA's thought-piece on the SOCs submitted in response to the RMR consultation also as feedback to the Call for Evidence. This document is attached as an appendix.

Regarding the Draft Enforcement Guidelines, the ERA's response concentrates on statement of case and the proposed new settlement procedure. Whilst there is not a consensus amongst our members on whether a settlement procedure should be a formal stage in Ofgem enforcement actions, there are some common concerns around the need to increase certainty, predictability and transparency of any arrangements.

The review of Ofgem's approach to enforcement

In addition to our comments above and the attached paper on SOCs, the ERA also hopes to submit further evidence to the review in due course. To assist us in doing so it would be helpful if Ofgem could provide more clarity on the timescales and milestones of the review. We have understood that

28 February 2012 is the deadline for responses on the Draft Guidelines. However, there was no such date provided for the Call for Evidence. We note that one of the key areas that Ofgem expects to examine is the enforcement approaches of other regulators. The ERA supports this, and would suggest that Ofgem might use the Joint Regulators' Group as a forum to discuss the subject.

Settlement Procedure

As stated above, our members do not share a common view on whether the settlement procedure should be a formal stage in Ofgem enforcement actions. However, should it be introduced, then we believe that Ofgem would need to make some adjustments.

The Draft Enforcement Guidelines state that Ofgem will "decide whether it is appropriate for the case to proceed through the settlement procedure"[1] and that this will be "considered against a range of factors"[2]. The ERA believes that the enforcement guidelines should state what those factors would include. In absence of such certainty and transparency, there would be a risk that the procedure is perceived as being open to arbitrary decision-making. In turn, this could jeopardise its credibility and uptake by licensees.

Where agreement for early resolution is reached between Ofgem and a company, it is suggested that the "investigating team will make a recommendation for early resolution to a Settlement Committee". The Guidelines state that the case will be considered "on the papers", however they do not seem to make clear how the recommendation will be presented, and in what form. For reasons of fairness, all papers submitted to the Settlement Committee should be agreed by the investigating team and the company. In addition, both the company and the investigating team should be allowed to present the recommendation to the Settlement Committee, should they wish to do so.

Supplementary Statement of Case

Paragraph 4.36 of the revised guidelines deals with, amongst other things, a supplementary statement of case (SSOC). It states that the case team may, following the written representations, close the case. Alternatively, "it may remain persuaded of a breach but consider it is necessary to amend its initial findings and prepare a supplementary statement of case". It does not envisage a second statement of case, rather it envisages some amendment to the initial findings (i.e. if Ofgem were no longer to consider, say, in the light of written representations, that an alleged breach can still be sustained). However, what can occur is that Ofgem can issue, what amounts to a revised, fuller and improved SSOC informed by the a supplier's response to an initial statement of case. In effect, it allows Ofgem a second bite of the cherry.

Such conduct would not be permitted under civil court procedure rules (Civil Procedure Rules 1998). Once served, a statement of case may only be amended with the consent of all other parties or with leave of the court. A party who has served a statement of case is not entitled simply to amend the statement of case and re-serve it on the other party. Unless that party consents to the service of an amended statement of case, leave of the court is first required. This is not given as a matter of course. Even if leave is not required because all parties have given consent to it, a court may subsequently disallow any amendment.

The rules are, understandably, even stricter in the case of criminal investigations, where there is an overriding objective that courts and everyone involved in a criminal case must deal with cases justly. For example, the prosecutor must disclose to the accused any prosecution material which has not previously been disclosed and which might reasonably be considered capable of undermining the case for the prosecution against the accused or of assisting the case for the accused. The prosecutor

[1] Ofgem, *Draft enforcement Guidelines on Complaints and Investigations*, ref 181/11, 16 December 2011, para 4.27, p. 27

[2] Ibid

must provide initial details of the prosecution case by serving those details on the court and making them available to the defendant at the outset of any action, and must contain certain prescribed information, including a summary of the evidence on which that case will be based. The rules also give courts explicit powers to actively manage the preparation of criminal cases to prevent unfair and avoidable delays and to promote certainty about what is happening for the benefit of everyone involved.

Financial Penalties Guidance

The ERA believes that there should be more opportunity for companies to consider, and if relevant make representations on, the order of magnitude of financial penalty that Ofgem is considering. Amongst other things, this could help increase the efficiency of resolution and assist companies in deciding whether to proceed with settlement negotiations.

In respect of financial penalties more generally, we note that the Statement of Policy remains as originally drafted in 2003[3]. We would ask Ofgem to consider whether a review is appropriate.

I hope that you find our comments useful. The ERA looks forward to further engagement with Ofgem during the course of the wider enforcement review. In the meantime, if you would like any further information, please contact me on 020 7104 4165 or alun.rees@energy-retail.org.uk

Yours sincerely,

Alun Rees
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[3] under section 27B of the Electricity Act (section 30B of the Gas Act)

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23 February 2012

ENERGY RETAIL Association

Dear Mr Hunt

Retail Market Review: Domestic Proposals

The Energy Retail Association (ERA), formed in 2003, represents electricity and gas suppliers in the domestic market in Great Britain. All the main energy suppliers operating in the residential market in Great Britain are members of the association - British Gas, EDF Energy, npower, E.ON, ScottishPower, and SSE.

The ERA is pleased to respond to Ofgem's proposals that are designed to enhance effective consumer engagement in the retail energy markets in Great Britain (GB), leading to greater and more effective competition.

Ofgem's RMR proposals are made up of a number of constituent parts. Given this, the ERA felt that it would be most useful to divide its response into three main elements:

- an independent impact assessment of the proposal to restrict suppliers to offering a single standard tariff per payment method undertaken by Frontier Economics;
- a thought-piece designed to encourage dialogue between Ofgem, suppliers and other stakeholders on the Standards of Conduct (SOCs) and proposed shift towards Principles-Based Regulation; and
- a high-level response that covers key principles behind the proposed reforms and other outstanding issues.

Given the differences in scope of these elements, we believe that they are best seen as discrete pieces of work. As such, we thought it would be most useful to submit them separately.

This document constitutes the second part, on which the ERA's members will also be providing individual responses. We would be happy to discuss any of the points made below in further detail with Ofgem if this is considered to be beneficial. In the meantime, if you would like any further information, please contact Alun Rees on 020 7104 4165 or alun.rees@energy-retail.org.uk

Yours sincerely,

Lawrence Slade
Chief Operating Officer

"Yet, it is argued, trust is the ultimate paradox. Principles-based regulation can help to create trust, but the core elements of that trust have to already exist if principles-based regulation is ever to operate effectively, if indeed at all."[1]

Ofgem is proposing to introduce Standards of Conduct (SOCs) as an "overarching, enforceable licence condition"[2]. The aim of doing so is to improve the treatment of customers across the industry and promote engagement, thereby leading to increased competitive pressures on suppliers[3]. It is believed that the SOCs will result in positive outcomes for consumers.

These are worthy goals indeed, and ones that the ERA wishes to see realised. However, will the shift towards principles-based regulations (PBRs) deliver them? Drawing on prevailing academic opinion[4], this paper argues that a move to PBR will not improve overall outcomes for consumers without change in other areas.

In particular, the ERA believes that the relationship between Ofgem and suppliers needs to be transformed. With the flexibility that SOCs provide, suppliers need to take responsibility to think through how they should be applied, fostering a "hearts and minds" ethos. In turn, Ofgem should aim to allow suppliers to take that responsibility with confidence, adopting an "educative and advisory"[5] approach to supervision and a two-stage enforcement process.

This recast relationship could assume the form of a "regulatory compact" that enables Ofgem and suppliers to build up a shared understanding of what the SOCs mean in practice through constructive dialogue. The compact would need to be founded on trust. Given current circumstances, this would be a significant challenge: it is one that would need to be fully accepted together, or not at all.

Potential benefits of SOCs

Ofgem is proposing "to recast the SOCs as wider-reaching, high level principles, using the spirit of the existing SOCs as a foundation."[6] This signals a shift towards Principles Based Regulations (PBRs), which the ERA acknowledges *could* in theory have a number of potential advantages over more traditional prescriptive rules:

1. Greater substantive compliance

Ofgem has expressed some concern, particularly with respect to the Probe Remedies, that suppliers' compliance with licence conditions has been to the letter rather than to the spirit, which is what Black calls "creative compliance"[7], and the risk that companies "hit the target but miss the point"[8]. By contrast, and as the Better Regulation Executive has recognised[9], PBRs focus more on the purpose of the rule and can ensure that companies' behaviour better aligns with the regulatory objectives, and so deliver positive outcomes.

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[1] Julia Black, *Forms and Paradoxes of Principles Based Regulation*, LSE Law Society and Economy Working Papers 13/2008 (hereafter Black, 2008), page 1

[2] Ofgem, *Retail Market Review – Domestic Proposals*, Ref 166/11 (hereafter RMR), 1 December 2011, p. 52 Chapter Summary

[3] Ofgem, RMR, para 4.15 p 55

[4] Primarily the work of Julia Black from the London School of Economics

[5] Julia Black, Martyn Hopper and Christa Band, *Making a Success of Principles-based Regulation* (Law and Financial Markets Review, May 2007) (hereafter Black et al, 2007) page 203

[6] Ofgem, RMR, para 4.21 p 56

[7] Black et al, 2007, p. 192

[8] G Bevan and C Hood, "What's Measured Is What Matters: Targets and Gaming in the English Public Healthcare System" (2006) 84(3) *Public Administration* 517

[9] HoC Regulatory Reform Committee, *Themes and Trends in Regulatory Reform*, 14 July 2009

2. Future-proofing

Prescriptive rules cannot be easily adapted to a changing landscape; PBRs could. As Ofgem states, "The principles-based nature of the proposed SOCs should mean suppliers are better-equipped to deliver benefits to consumers in the context of technological, and other, change. For example, they may be more likely than prescriptive measures to retain their relevance as we roll out smart metering."[10]

3. Leadership of senior management

There is more judgment involved in working out how to comply with PBRs than with prescriptive rules (it is probably more straightforward to determine whether a specified process has been followed). Thus, under PBRs the compliance function naturally assumes a more strategic role, with more decisions being made by senior management, in this case fostering a company-wide instillation of the SOCs.

4. Lowering of compliance costs

Ofgem states that suppliers will "have a degree of flexibility with regard to how they meet the SOCs" and therefore that "the additional cost required for a competitive supplier to meet our standards – which would ultimately be borne by consumers – would be low."[11] The reduction in compliance costs should also be assisted by "limit(ing) the need for more prescriptive measures in the future"[12]. The flexibility is particularly important for smaller suppliers and new entrants who can adopt solution befitting of their size, or the niche market they serve.

Addressing the "failure factors" and underpinning the advantages

The SOCs could have a number of advantages over more prescriptive rules *in theory*. However, whether these advantages can be realised *in practice* depends on the behaviours of the parties involved, and particularly how the SOCs are applied and enforced by the regulator.

The following section highlights a number of steps that the ERA believes Ofgem needs to take before the potential advantages for consumers are realised.

1. Adopt a two-stage enforcement process

As with any licence condition, the way in which Ofgem enforces any SOCs will in part shape suppliers' response to them. Therefore, it is not possible to know the *effect* of the SOCs until the way in which they will be enforced is determined[13].

Under PBRs, enforcement would assume a particular importance. Since there will be less prescriptive rules, suppliers will naturally base more of their behaviour on how they think Ofgem *will* react (rather than how they think Ofgem *should* react, based on the prescription given). Therefore, if Ofgem provides information that allows suppliers to understand how they will react, then they (suppliers) are more likely to act in what Ofgem perceives to be the "right" way.

However, as we have seen (and Ofgem recognises[14]), one of the main benefits of PBRs is that they could allow suppliers the flexibility to develop innovative solutions, which meet the regulatory objectives at low cost to the business, and could also bring new benefits to consumers. In this sense,

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[10] Ofgem, *The Retail Market Review: Draft Impact Assessment for Domestic Proposals* (hereafter IA), ref 166A/11, 1 December 2011, para 1.38 p 101

[11] Ofgem, IA, para 1.39 p 101

[12] Ofgem, RMR, para 4.22 p 56

[13] It is therefore surprising that Ofgem states that it is yet to "consider what compliance and enforcement processes may be most appropriate when enforcing principles-based requirements" - see RMR, para 4.27 p 58

[14] Ofgem, RMR, para 4.22 p 56

the SOCs are founded on the idea that there is no "right" way; as much as suppliers, Ofgem should be prepared to learn, adapt and accept that different suppliers will apply different solutions.

Ofgem is thus faced with a dilemma. It seems that for the SOCs to work, suppliers would need guidance but not too much prescription. This, according to Black, is the key question: "how to provide both certainty and predictability whilst giving firms the flexibility and space to innovate that Principles can create"[15]. The four other measures listed below should help in this regard. But whilst they are necessary, they are not sufficient.

The ERA believes that the most important *measurable* adjustment that Ofgem could make to help ensure that the SOCs work is to adopt a two-stage enforcement process similar to the bespoke arrangements established by Ofgem for SLC 25A[16].

A "two-stage regime" would involve an initial stage of informal but structured dialogue between regulator and regulated that enables a "without prejudice" exchange of views on what behaviours constitute compliance. Should Ofgem maintain that the behaviour is unacceptable subsequent to discussions, the licensee would be provided with reasonable time to remedy what the regulator considers to be a breach before they become liable for a penalty or enforcement order.

However, we recognise that further consideration would need to be given to how a two-stage regime would apply to situations where the licensee's account of its behaviour is plainly inconsistent with the principles and/or there is evidence of serious consumer detriment.

Some of the benefits of such a regime have already been noted, including giving suppliers confidence to come up with new ways of meeting consumers' needs. However, there are other important advantages. Firstly, it could help prevent continuation of a detrimental policy - sophisticated dialogue militates against positions "hardening" by allowing parties room to be persuaded without embarrassment or it being seen as evidence of a breach. Secondly, it will help to promote trust in the industry by ensuring an appropriate balance of disclosure, given that investigations cause reputational damage even when no breach is found.

2. Be willing to give "straight answers to straight questions".

Under a principles-based regime, dialogue between Ofgem and suppliers *has to be* the central method of developing a shared understanding of the requirements of the SOCs if guidance is not to proliferate and/or interpretation is not to be determined by enforcement cases.

This dialogue will not take place unless suppliers are able to approach Ofgem and discuss their responses on a "without prejudice basis", and trust that they will not face enforcement action if the Regulator does not agree their solution delivers the intended result. The FSA recognised the need to shift its ways of working in this direction[17].

3. Ensure that policy and enforcement teams are joined-up

One of the Government's Principles for Economic Regulation is predictability; to provide a "stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence."[18]

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[15] Black et al, 2007, p. 197

[16] Prohibition of undue discrimination in supply

[17] FSA, *Principles Based Regulation*, April 2007, p. 12 - Notwithstanding these points, it is important to recognise differences between financial services and energy markets, particularly the degree of variation in the products that each regulated firm within that each market offers, as opposed to the service.

[18] DECC, *Ofgem Review – Final Report*, July 2011, p 10

With this objective in mind, the ERA is proposing a recasting of the relationship between Ofgem and suppliers, where the former is prepared to validate the latter's response to the regulatory framework. But this will not work if different divisions within Ofgem have different expectations, and tell suppliers different things. As the FSA said, for PBRs to work, "firms must have more trust and confidence in the behaviours, competence and judgement of our people"[19].

4. Ofgem should adopt a clear policy that it will not seek to effect a significant change on industry behaviour on the basis of the SOCs without undertaking a consultation process and Impact Assessment[20].

The Government's Principles for Economic Regulation state, inter alia, that "decision-making powers of regulators should be, within the constraints imposed by the need to preserve commercial confidentiality, exercised transparently and *subject to appropriate scrutiny and challenge*"[21] (ERA's emphasis).

Ofgem seems to be confident that "the new SOCs are drafted in a way that enables suppliers to understand how they can meet the principles they contain"[22]. Despite this, Ofgem admits that guidance may be needed to provide necessary clarity[23]. According to the draft licence conditions[24], such guidance could be issued without prior statutory consultation and Impact Assessment, and licensees would also be bound to have regard to it.

Depending on the importance that Ofgem and suppliers attach to guidance issued under the SOCs (presumably high, based on the drafting), the process described in the paragraph above would bypass the checks and balances built into Ofgem's rule-making, including suppliers' right of appeal to the Competition Commission. We would be at risk of seeing the establishment of rules-based regulation by the back-door.

That Ofgem does not forget its responsibilities is even more important now it can make licence changes without the approval of a qualified majority of licensees[25]. Due process must be followed where guidance is introduced, and Ofgem needs to emphasise its status where non-binding. In terms of practical measures, Ofgem should consider adopting the FSA's mantra of guidance being deployed as a "shield and not a sword"[26].

5. Ofgem should rarely, if ever, undertake enforcement action on the basis of SOCs alone.

The concerns expressed in (4) above regarding the potential for Ofgem to bypass statutory checks and balances apply equally to enforcement as they do to guidance. Enforcement of any SOCs could establish precedent, which licensees will have regard to in their compliance decisions. If arbitrary

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[19] FSA, April 2007, p. 18

[20] See Black et al, 2007, p. 203

[21] BIS, *Principles for Economic Regulation*, April 2011

[22] Ofgem, RMR, para 4.27 p 57. Contrast this with an earlier statement: "(w)e considered that inserting the standards as a preamble to the licence conditions would give rise to interpretative difficulties in relation to the text of the new licence conditions, thereby leading to possible legal uncertainty" (Ofgem, Energy Supply Probe – Proposed Retail Market Remedies, Ref 99/09, 7 August 2009, para 2.9 p 7)

[23] Ofgem, RMR, para 4.27 p 57

[24] Ofgem, RMR, p. 79 1A.5

[25] In this regard, it is worth pointing out that the UK Government *did not* choose to exceed the minimum requirements of the EU Third Energy Package because it thought that Ofgem should have additional autonomy (i.e. for policy reasons). Rather, it was done to reduce complexity and the likelihood of decisions getting stuck in a legal quagmire. See DECC consultation of licence modification appeals, September 2010.

[26] See Black, 2008, p. 23 – "In other words, conduct in accordance with the guidance can be used as a 'shield' against enforcement action (though it does not have the formal status of a safe harbour), but non-conformity with the guidance will not be used as a 'sword' by the FSA with which to impale firms".

regulatory creep is to be avoided[27], any SOCs should be used as an aid to interpreting existing and future licence conditions in the vast majority of cases. Similarly, where prescriptive rules-based licence conditions are already laid down, it would not seem appropriate to enforce the prescriptive condition on the basis of SOCs alone. If Ofgem envisages doing so, then this would imply that the prescriptive condition is not fit for purpose.

A related concern is Ofgem's declared intention "to apply these provisions to all supplier interactions with consumers"[28]. This would be a broad scope indeed. We presume that this would not include activities that are not covered by the supply licence, and would ask for Ofgem's assurance in this regard.

What does failure look like?
The changes suggested above are designed to assist suppliers to determine what they need to do to comply with any SOCs and/or give them the flexibility and confidence to take responsibility and develop innovative solutions that result in improved outcomes and new benefits for consumers.

If SOCs were introduced in absence of these changes, suppliers would have little or no assurance as to what would constitute compliance. The lack of certainty would tend towards overly-cautious behaviour, exacerbated by the high standard of "all reasonable steps"[29], and higher costs. In such circumstances, suppliers could not plan their business with a reasonable degree of assurance[30].

Developing innovative ways of meeting any SOCs, thereby finding new ways of providing good customer service, would be risky and so avoided. Indeed, suppliers would be more likely to spend their time trying to second-guess what Ofgem believes is the "right" behaviour, rather than think it through themselves. Overall, increased regulatory risk and disincentive to innovate would act as a barrier to entry and disproportionately impact on smaller suppliers.

Guidance would probably proliferate in order to fill the certainty void created by the lack of open and honest dialogue between suppliers and Ofgem about what an appropriate response to any SOCs is. The resulting prescription would undermine the flexibility that standards are supposed to create, further increasing complexity and compliance costs. A tide of "enforcement-led" regulation, stemming from a breakdown in the relationship between regulator and regulatees, would have similar consequences and potentially exacerbate consumer distrust in the industry.

Rather than promoting better treatment of customers, SOCs could unintentionally provide a disincentive to going the extra mile, since regulated firms might fear being held to a fixed solution if it was initially adopted. This throws Ofgem's assertion that competition will be enhanced into question. For the same reasons, we may see a decreased appetite for self-regulation.

Conclusion: dialogue is the way forward and trust would be the catalyst to success
The ERA believes that PBR could help deliver good outcomes for consumers, but only if suppliers and Ofgem are prepared to make a number of changes to their *modus operandi*.

Since the consultation document does not mention any conditions for successful operation of any SOCs, we consider the proposals to be incomplete[31]. As a next stage therefore, we believe that

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[27] An associated benefit would be to reduce the burden of trying to make sense of the accumulated body of case law.

[28] Ofgem, RMR, para 4.23 p 57

[29] And not to jeopardise the ability to achieve

[30] This is a statutory duty for other regulators, including the Office of Rail Regulation

[31] In addition to the points made above, we suggest that it would be desirable for Ofgem to assess the efficacy of the precedents that it cites in support of its proposals in paras 4.12 and 4.13 of the RMR

Ofgem and suppliers should discuss which changes are necessary to the proposals and how realistic they are, with a view to reaching agreement on the best way forward.

It is also hoped that through open and positive dialogue, each party will be able to appreciate the other's willingness to adapt their mindset and behaviour, thereby building the trust that is a prerequisite for success of the more formal elements. However, building this trust depends on actions as well as words; both parties would be likely to want to see practical evidence of change to support the process.

As Black said of financial regulation, "(a) more Principles-based regime will require a revolution in the relationship between firms and the FSA. It may well be that this would be a change significantly for the better, but it will only work if attitudes change correspondingly"[32].

[32] Black et al, 2007, p. 200