

Future retail regulation

7 July 2015

ofgem

Welcome

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10:15 – 10:20	Welcome
10:20 – 10:45	Presentation from Julia Black
10:45 – 11:10	Direction of travel
11:10 – 11:15	Break
11:15 – 11:25	Workshop process description
11:25 – 14:15	Breakout groups (incl. lunch 12:25 – 13:15)
14:15 – 14:25	Break
14:25 – 14:45	Feedback on breakout discussions
14:45 – 15:05	Q&A
15:05 – 15:20	Closing remarks

Principles Based Regulation

PROF JULIA BLACK, LSE

OFGEM WORKSHOP, 7TH JULY 2015

Outline

Context

What is PBR?

- PBR in the rule books
- PBR in operation

Why have PBR?

Risks and challenges of PBR

Context

Broad context of the 'better regulation' debate

- how to deliver effective, proportionate and targeted regulation without compromising the achievement of social and economic objectives

Regulatory 'fashions'

- 'New governance' / 'smart' / 'better' regulation techniques
 - Key features:
 - Flexible and responsive
 - Hybrid – combine government, industry, market, NGOs, trade associations etc
 - Anything – but not 'command and control'

Current trends

- Principles based regulation – but reputational damage from the financial crisis
- Outcome focused regulation – less tainted label (so far)
- Risk based regulation

Some adopters of PBR or OFR

Some examples

- Human Fertilisation and Embryology Authority
- Financial Reporting Council
- Local Better Regulation Office (before abolition..)
- Care Quality Commission
- Legal Services Board
- Solicitors Regulation Authority

What is PBR?

Term of art not science

Forms of PBR

- Rule book PBR
- Operational PBR

Rulebook PBR

Rules contains high level principles

- Principles express the fundamental obligations that all should observe
- In particular
 - they are drafted at a high level of generality
 - they contain terms which are qualitative not quantitative
 - they are purposive and outcome orientated

Examples

‘A firm must conduct its business with due skill, care and diligence’ (FCA Handbook, Principles for Business, P2)

‘A firm must pay due regard to the interests of its customers and treat them fairly’ (ibid, P6)

‘You must uphold the rule of law and the proper administration of justice’ (SRA Handbook, P1)

‘[Licensed centres must] ensure that all premises, equipment, processes and procedures used in the conduct of licensed activities are safe, secure and suitable for purpose’ (HFEA Code, P8)

Why bother?

A number of political answers, eg

- Institutional positioning of the regulator
- Agenda setting
- Reputation – ‘leader’ / ‘best practice regulator’

Technical answer – rule type as a distinct regulatory technology and set of policy choices

Technology of rule use – linked to what we want from rules

- Straightforward to apply
- Certainty
- Achieve their purpose even in changing contexts
- (for regulators) – to reduce scope for gaming or ‘creative compliance’; prompt a ‘purposive’ approach to compliance

What we can get from different types of rules

- Tradeoffs in using rules

Tradeoffs in using different types of rules

Property / Rule Type	Ease of application	Drafting of the rule is congruent with the rule's purpose	Certain – people know what they have to do to comply	Scope for gaming / complying with the letter not the spirit
Bright line rule (eg speed limit)				
Principle				
Complex set of rules or standards				

Rule book PBR & rule ‘tiering’

Tiered *rulebook* structure – single author

- Principles elaborated in rules & guidance
 - By same regulator

Tiered *rule system* structure – multiple authors

- Use of principles deliberately to confer interpretive discretion
 - Principles act as basis for harmonisation of regulatory regimes
 - designed to be elaborated by other regulators
 - Principles act as formal basis for including other actors in the regulatory regimes
 - Regulator encourages / permits professional bodies, trade associations, regulatees etc to formulate codes, guidance etc

Some issues to note

Note that de facto discretion always conferred even where rules are detailed

- The more complex the rule system the greater the likelihood of gaps and inconsistencies – and therefore need for discretion in interpretation and application

Behavioural assumptions associated with different rule types - are they valid?

- Which types of firms respond better to detailed rules and which to principles?
 - Large, well resourced firms vs SMEs?
- Which personnel within firms respond better to detailed rules and which to principles?
 - Compliance / middle management vs senior management?

For regulators – institutional structures matter

- Key issue becomes question of who has interpretive authority: enforcement context critical

Operational PBR

‘Merging’ of PBR, OBR and other regulatory approaches

Rule book PBR can be associated with a number of additional regulatory practices

- an orientation to outcomes
- an explicit and developed reliance on firms’ internal management as part of a revised approach to compliance
- a reallocation of responsibilities for working out the practical application of the regulatory provisions

PBR and Regulatory Practices:

(1) Outcome orientation

Implications for firms of moving to an outcome based approach:

- flexibility (and responsibility) for firms / licensees to develop their own ways of achieving the outcomes specified

Implications for regulators:

- identifying what the important outcomes are and developing methods to assess them
- communicating that effectively to firms

PBR and Regulatory Practices:

(2) Reliance on firm's internal management

Emphasis on responsibility of firm to ensure compliance Eg Ofgem's Compliance Principle 1 (2014)

- Can include a focus on internal management and controls as risk mitigators / risk enhancers

Implications for firms:

- Need to elaborate on how to apply Principles and how to demonstrate compliance
- Need for enhanced procedures and demonstration that achieving outcomes

Implications for regulators:

- Move away from 'tick-box' compliance assessments to deeper analysis of firm's activities and the exercise of judgement
- Requires a different type of engagement and a different type of skill set for compliance personnel in regulators (and firms)

PBR and Regulatory Practices:

(3) Reallocation of responsibilities

With flexibility comes responsibility

Implications for firms and regulators: principles can remove the 'prop' of detailed rules, though rules often remain

Implications for regulators

- Role for guidance and clarity from the regulator
- Requirements to exercise judgements and make commitments

Implications for firms

- Requirements to exercise judgement and 'think through' the application of the regulatory requirements

New 'regulatory bargain' but

- Firms' requirements are contradictory – to have 'light touch' regulation but to know just what they have to do
- Terms of the 'bargain' are endlessly contested as to what the balance of responsibilities should be between regulators and firms

Paradoxes and Pathologies of PBR

Interpretation

- Accepted interpretation of general principles can be quite specific

Communication

- Communication hindered by a confusing multitude of guidance notes, speeches, open letters etc

Compliance

- principles provide scope for flexibility in compliance yet can lead to conservative and/or uniform behaviour by regulated firms - prompted by interpretive risk

Pathologies and Paradoxes cont.

Supervision & enforcement

- principles need enforcement to give them credibility but over-enforcement can lead to their demise

Internal management paradox

- PBR can provide flexibility for internal control systems to develop but can overload them

Ethics

- PBR can facilitate a more ethical approach but it could result in an erosion of ethics – compliance (turned into) a risk / benefit question

Trust

- PBR requires trust in all by all for it to function – but of itself cannot provide that trust

Summary

PBR: Does it travel? Do you want it?

Complex regulatory technique

- Rulebook & operational – though can have one without the other

PBR can lead to far reaching changes in dynamics of regulatory regime

But pathologies and vulnerabilities

Overriding prerequisite: trust

Direction of travel

Adhir Ramdarshan

Head of Domestic Retail Market Policy

The problem

Companies can avoid thinking for themselves

Relentless pressure to create more rules to plug gaps

May prevent innovation and deter new entrants



Increasing reliance on regulation through principles could address these issues

Focuses minds on important consumer outcomes

Supports innovation – durable to market developments

Requires use of judgement about what's right for consumers – elevating compliance to the boardroom

Phase 1 (May-Dec 2015): Scoping future regulation

Output will be consultation on high-level strategy and way forward at the end of 2015

Support for increased
reliance on principles

There is still a strong role for
prescription in some areas

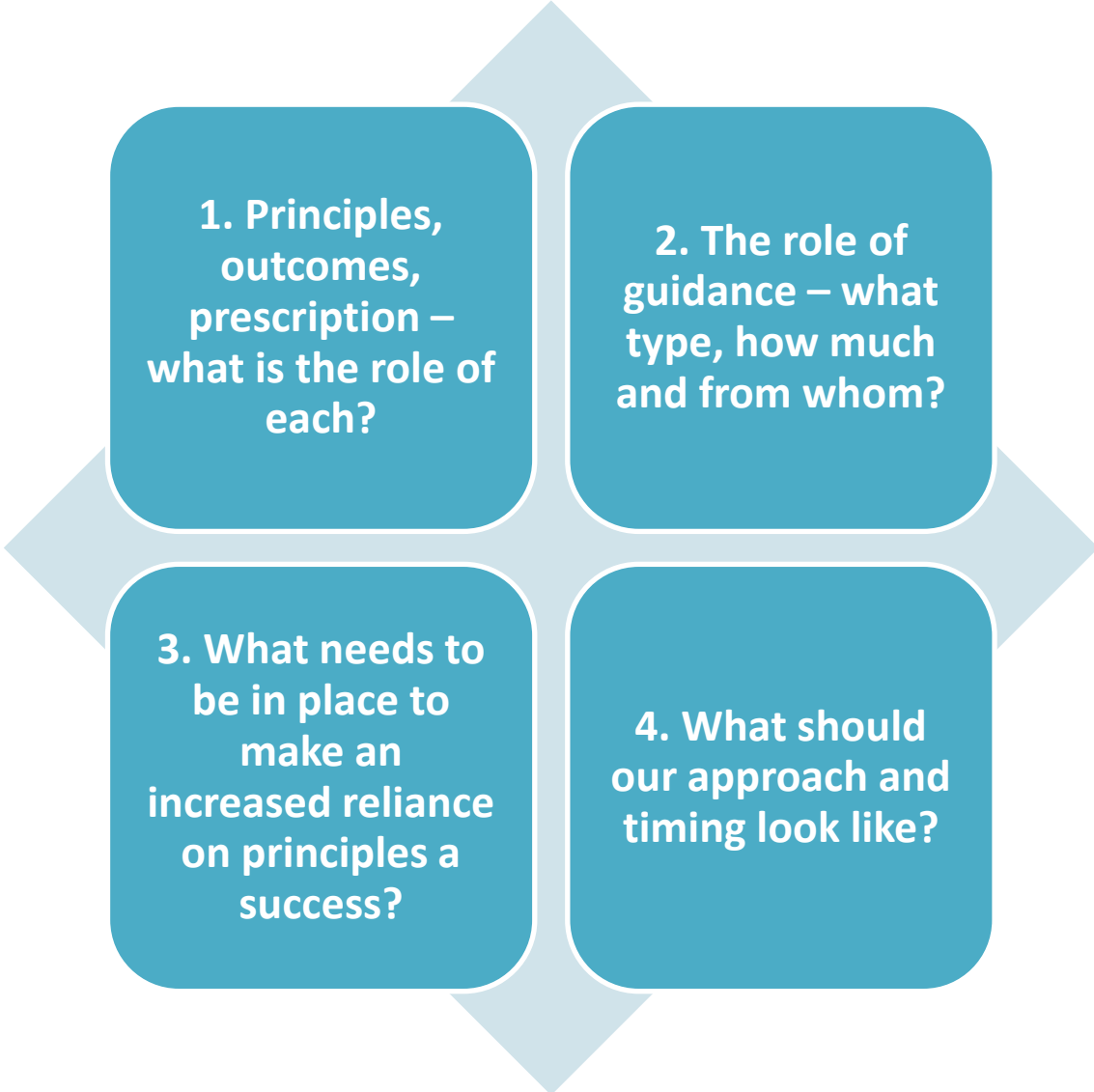
Importance of
building trust
across all parties
(incl. consumers)

Broad agreement in some
areas from our conversations
with stakeholders so far

Principles should not
be voluntary

Major culture changes will
be required – both for
suppliers and for Ofgem

Continuous and effective
dialogue between suppliers and
Ofgem is extremely important



1. Principles, outcomes, prescription – what is the role of each?

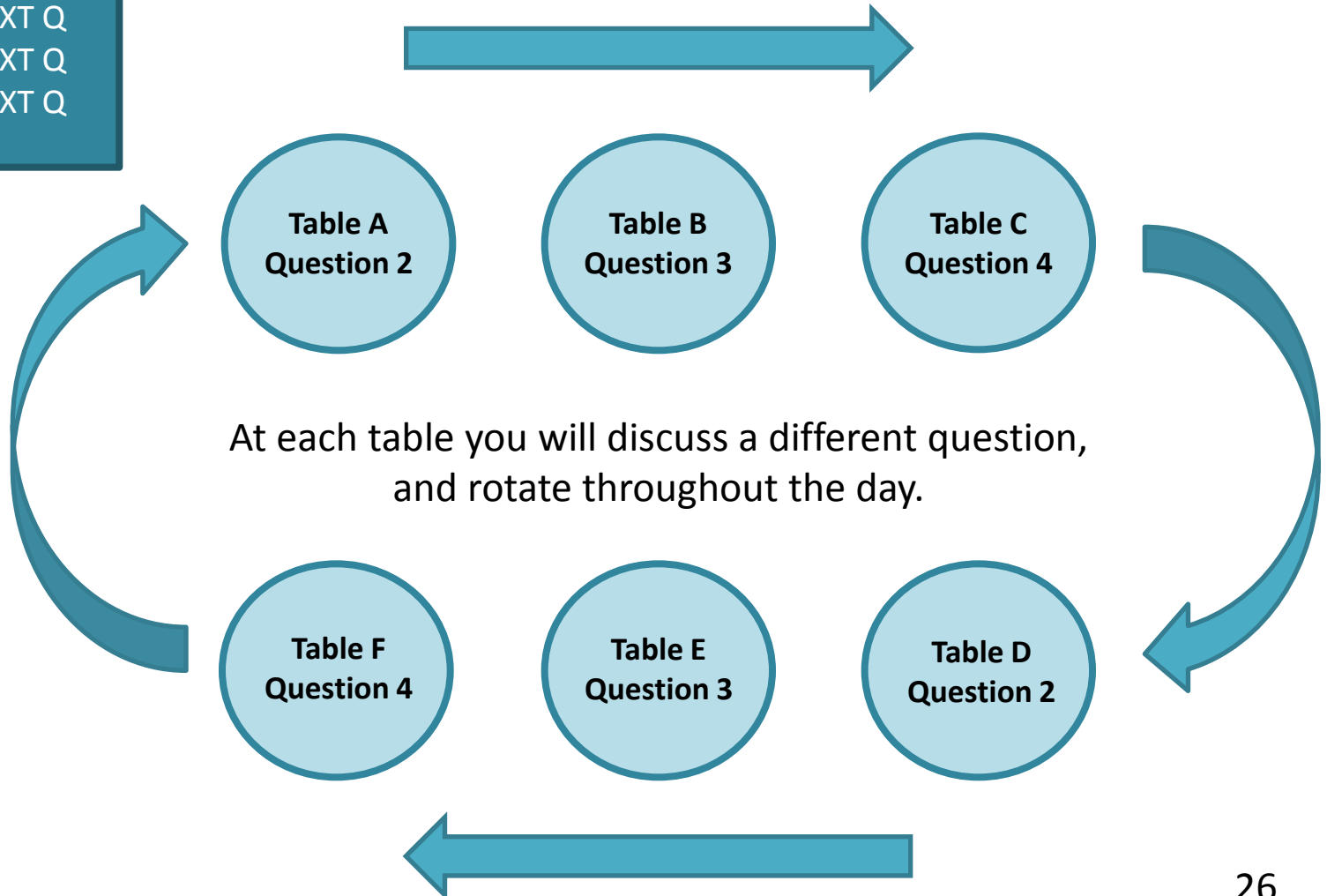
2. The role of guidance – what type, how much and from whom?

3. What needs to be in place to make an increased reliance on principles a success?

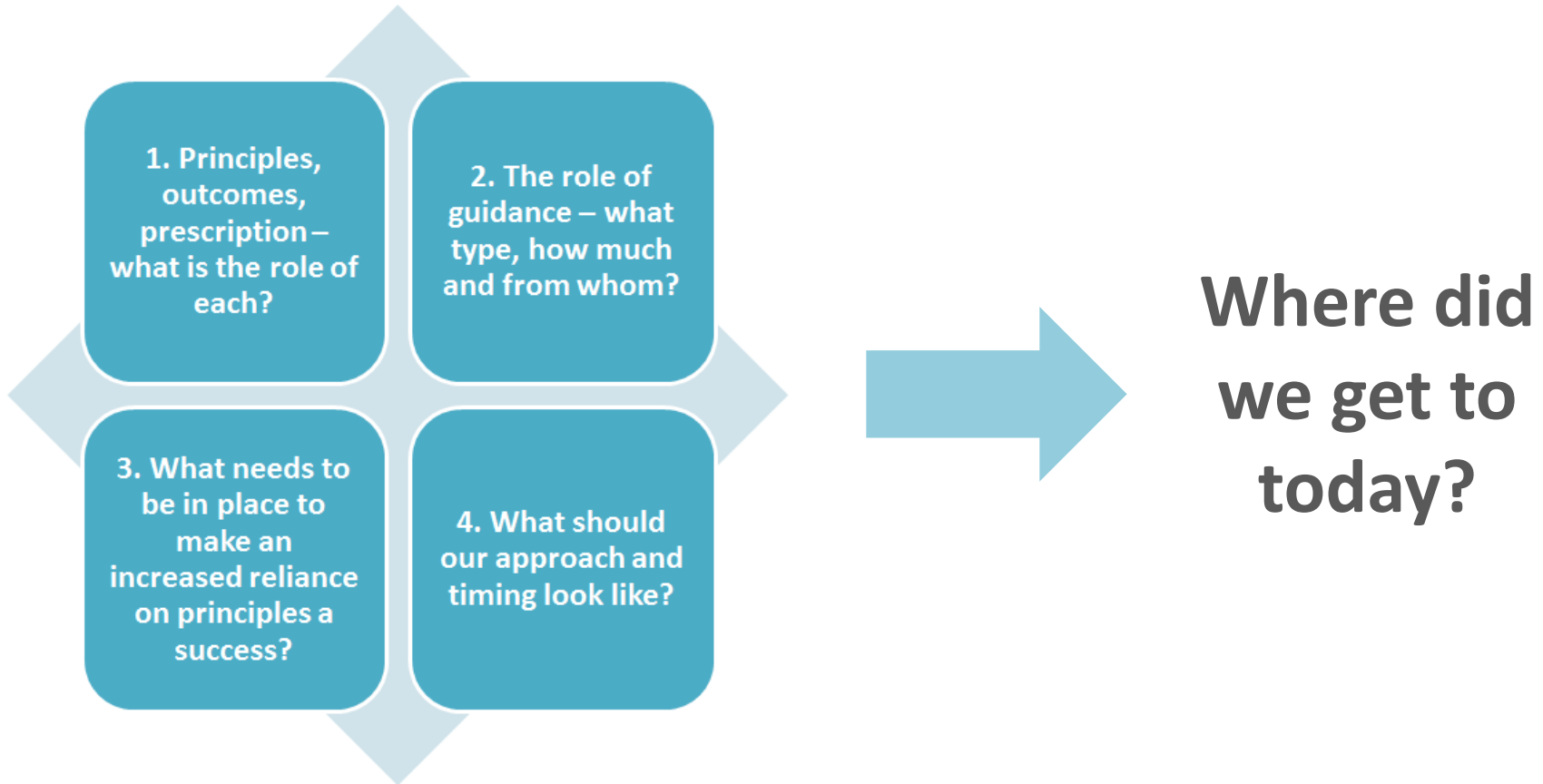
4. What should our approach and timing look like?

Workshop process

11:25 – 11:55 Q1
11:55 – 12:25 NEXT Q
13:15 – 13:45 NEXT Q
13:45 – 14:15 NEXT Q



Feeding back today's learnings



Q&A

Close and next steps

For questions or to discuss any of these issues further (we want to hear from you!), please contact:

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