

Via email: futureretailregulation@ofgem.gov.uk

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Dear Adhir

THE FUTURE OF RETAIL MARKET REGULATION

Thank you for the opportunity to respond to the Ofgem consultation on *The Future of Retail Market Regulation*.

Gemserv's experience and understanding of the regulation and governance of energy markets is extensive. Many of our people come from the industry it serves, people that have a deep and comprehensive understanding of the regulated energy sector and practical experience of the regulated businesses that operate within that market. We therefore trust that our response will provide Ofgem with useful insight and an objective perspective as it moves forward to remove unnecessarily prescriptive regulation, i.e. to deliver licences that are shorter, more accessible and clearer.

Our assessment is that energy supply licences are already (to some extent) a mix of broad-based, narrow-based and prescriptive rules. It is only in recent years that licences have become more prescriptive in nature, driven ostensibly by environmental policy and consumer detriment concerns - SLC 31D (white label tariffs) is a case in point. Our analysis is that, by concentrating on those Standard Licence Conditions (SLCs) that are still prescriptive, and assessing those in terms of key criteria, it could be possible to reduce licences by around 50% by volume. This of course depends upon the level of risk that Ofgem is prepared to take and the need to ensure that the exercise is not simply a 'lift and shift' of obligations into other places, such as within codes.

We have responded to Ofgem's specific questions in Appendix 1, focusing on the overall principle based framework (where we can add most value) rather than commenting specifically on SLC 25. In summary, we make four key points:

1. We agree with Ofgem's approach, one that recognises there is a place for broad and narrow principles, as well as prescriptive rules. The challenge is where and how to strike that balance and the need to ensure consistency of application. We offer an assessment approach to help.
2. Prescriptive rules should be focused where there is a need for organisations to come together in order to support common/shared services and outcomes, or where the risks are simply too great (e.g. consumer harm).
3. An incremental approach to more principle based regulation is necessary so that behavioural adjustments can be made by energy companies and for Ofgem to equally adjust its methods to reduce the risk of negative customer impacts. Ofgem's proposed phased priority based approach is therefore a good way forward to help build trust and confidence.

4. We agree with Ofgem that developing the appropriate framework is important. A greater shift to principle based regulation should be assessed against agreed policy areas and clearly defined criteria. Criteria will help avoid the potential for regressive harm to energy market interoperability and to customers themselves. Moreover, it will strike an appropriate duty of care with respect to market interoperability and investor confidence.

We agree there is room to deliver licences that are shorter, more accessible and clearer and importantly, an opportunity to facilitate greater levels of innovation and facilitation of new business practices. However, there are clearly risks with any change, especially one of such significance.

Whilst the presumption should be to move to principle-based regulation wherever possible, prescription is particularly important where organisations must come together in order to support common/shared services and outcomes or where the risks to customers are particular great. Where this is not the case, there is greater scope for principle based regulation especially where there are natural market incentives to drive the right behaviours, e.g. customer billing,

Please let me know if we can help further with your work and the development of a framework/methodology that strikes an appropriate balance between risk and outcomes.

Yours sincerely



Tony Thornton

Head of Transformation

APPENDIX 1: RESPONSES TO SELECTED CONSULTATION QUESTIONS

CHAPTER 2: REFORMING THE RULEBOOK

Question 1: In what circumstances do you think that prescriptive rules are likely to be most appropriate? Which specific SLCs/policy areas should remain prescriptive in nature?

Our assessment is that energy supply licences are (to some extent at least) already a mix of broad-based, narrow-based and prescriptive rules. It is only in recent years have licences become even more prescriptive in nature (intrusive to some extent), driven ostensibly by environmental policy and consumer harm concerns, SLC 31D (white label tariffs) being a case in point. Our analysis suggests that, by concentrating on those that are particularly prescriptive, and assessing those in terms of key criteria, it should be possible to reduce licences by around 50% of their volume. Further, by setting down a sound framework, clear assessment criteria, and a review mechanism, it should be possible to avoid a creep back to overly intrusive regulation.

However, there are risks as well as benefits to consider in a lessening of prescription based rules. A move away from prescription and towards a more principled based regulated approach should consider the following:

- Principle based regulation allows for creativity and innovation, i.e. it allows for new market models to flourish through creative ventures. However, it also allows for processes and practices that are more opportunistic by nature, i.e. interpretation of principles could lead to negative effects, possibly leading to consumer harm and reduced consumer confidence and engagement in the competitive energy market.
- Prescriptive rules set out a blue print for new entrants. In other words, it frames what must and must not be done - it acts as a specification for market entry and as an aid for traditional market entry models with minimum risk to consumers. However, the sheer weight of rules to be read and understood could also act as a deterrent to innovative business models, so clearly a balance must be struck.
- Market interoperability, especially with respect to customer switching, relies on very precise rules being set down (e.g. standards). These market 'hand-shakes' ensure that all industry participants know what to expect and when (e.g. data flow exchanges). If the shift to principle based regulation is not handled carefully, there is a risk that important energy market processes become out of alignment leading to increasingly poor customer switching experiences and increased customer complaints. Prescriptive rules also confer legal rights and supporting processes to ensure that problems can be effectively resolved.
- A shift away from licences that are prescription based, could result in more detailed rules being developed elsewhere (e.g. within codes), especially if the result causes problems with market interoperability. Ofgem are keen to avoid back door regulation, so the application of principle-based regulation needs to be very carefully determined and consistently applied using clearly defined and agreed criteria.

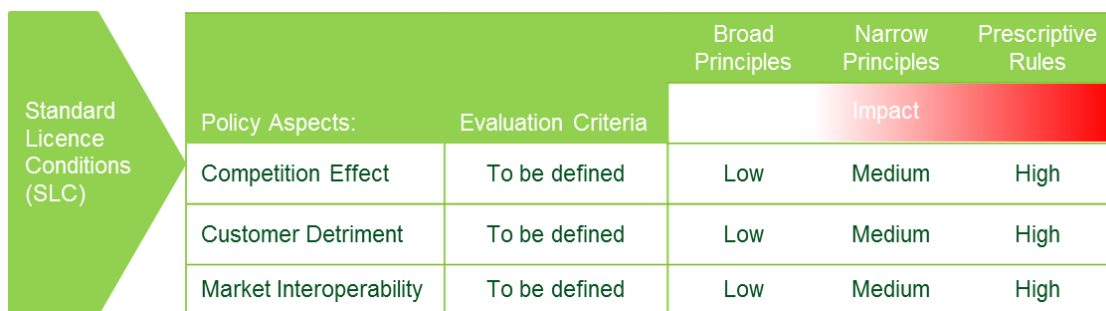
A sound, transparent assessment framework will support market confidence. It will be important to be very clear about who sets the prescriptive rules, where they should be held (e.g. licence or codes), how best to ensure they are open to development / evolution (change), whilst being capable of challenge. A shift to principle-based regulation should be applied consistently, across all licences and within licences. Further, there needs to be a

good understanding of where natural market incentives e.g. commercial pressures, can drive the right outcomes without prescription (customer billing could be one such area). Gemserv therefore offers up its ideas on how Ofgem’s framework could evolve.

The framework could base its assessment on clearly defined criteria, set to address a range of factors including risk, benefits and incentives. The criteria could be centred around three specific policy aspects:

- Competition effects;
- Interoperability effects; and
- Consumer detriment effects.

The extent to which broad-based, narrow-based or prescription rules apply, should be informed by a risk assessment across these three policy aspects. Given there are multiple policy areas to risk assess, our suggested approach is for the regulatory route to be predicated on the highest risk. For example, if the criteria determines the competition effect is medium but the customer detriment is high, then it follows that prescriptive rules are best.



Standard Licence Conditions (SLC)			Broad Principles	Narrow Principles	Prescriptive Rules
	Policy Aspects:	Evaluation Criteria	Impact		
	Competition Effect	To be defined	Low	Medium	High
	Customer Detriment	To be defined	Low	Medium	High
	Market Interoperability	To be defined	Low	Medium	High

Figure 1. Principle Based Impact Model

We have proposed above a simple model to aid understanding, underpinned by criteria that will need to be properly defined. A consistently applied methodology will avoid principle based regulation potentially undoing the good that has been built up over the many years of market operation. The criteria once defined should protect existing market participants from the actions of potentially negative opportunistic new business practices and a misalignment of existing central services where inter energy company dependencies are critical. It also maximises the space for innovation where it matters most, i.e. at the interface between the energy company and their customer.

For example, with regard to market interoperability, we believe that codes play a fundamental role ensuring that market participants can come together in exercising their rights and obligations, in a manner that ensures a level playing field and protection for customers. Interoperability is supported by SLCs that require industry parties to come together to be party to certain codes. This implies a high risk for which prescription based rules are likely to be warranted. The model also allows for interoperability practices that could be considered as low risk; for example, between two parties where others are not impacted and where the risk is considered small.

Question 3: Where might narrow principles be more appropriate than broad principles or prescription?

There should be no policy area that is excluded from being considered for narrow or broad based principles, rather it is the level of risk that is critical (as modelled in Fig. 1), i.e. following the use of predefined criteria to undertake that assessment.

It is unclear at this stage to Gemserv how to best classify SLCs as either principle or prescription based, when determining suitable candidates for principle based regulation, and thus where narrow principles should prevail over broad. For example, electricity supply licence SLC11 (Compliance with Codes) requires that “...*the licensee must be a party to and comply with the Master Registration Agreement...*” Is this already narrow-based or is it prescriptive? It raises an important question about what we really mean by narrow-based principles and how best to define it. Ofgem’s model example in Fig 2 of its consultation (page 13) whilst extremely helpful, still leaves interpretative room, especially where a licence condition points to other regulatory and/or governance instruments where all the detail is held.

What is important is to first agree the framework (and criteria) against which assessments must be made. Our proposed policy model could be a good place to start, although it may be overly simplified and need refining. The assessment criteria that evolve from the framework will help with the critical assessments that should then take place. This approach will support regulatory certainty and transparency around SLC changes in the application of greater principle-based regulation and aid market (and investor) confidence.

Question 5: How should we use principles and prescription to most effectively protect consumers in vulnerable situations?

We believe that a wider perspective should be taken, namely that the tests should not solely be about vulnerability per se, but about consumer detriment as a whole. A customer that is not considered ‘vulnerable’, may still need a level of protection that goes beyond principle-based regulation. That said, it is very likely that one of the key criteria for assessing consumer detriment will be a vulnerability test.

However, we note that the debate on how to define vulnerability continues. We believe this is because there is a genuine need to ensure that customers that may be disadvantaged in some way should also be protected (i.e. suffer undue detriment). Widening the vulnerability definition means that energy companies become less clear on how best to target measures, potentially diluting the protection for the most-needy in our society under a principle based approach.

We therefore recommend that with regard to the shift to principle-based regulation, that Ofgem adopt customer detriment criteria for assessment purposes. We believe this would avoid confusion between what constitutes ‘vulnerability’ and which should be framed in a manner that targets very special needs, and the particularly severe aspects of customer detriment where they may not be sufficiently empowered to take action¹. In 2014, the Department of Business Innovation and Skills (BIS), published its Consumer Engagement and Detriment

¹ *Consumer Empowerment TNS Eurobarometer 342 April 2011 and Consumer Empowerment in the EU Commission Staff Working Paper April 2011*

Survey² – i.e. consumer detriment can take many forms. This may provide a useful input on how to shape the policy area on consumer detriment. Also, focusing on how empowered customers feel, could help strike the right balance between the potential for harm and the ability of the customer to take action. For example, punitive contract terms could be an area where customers are less empowered to force change and if the financial effects are severe, it may therefore require more prescriptive-based regulation.

The key is to ensure that the criteria for assessing consumer detriment are well calibrated, i.e. just because there is the potential for harm does not of itself constitute a sufficient reason to warrant prescription-based regulation. One of the tests could be whether there are other drivers and/or incentives that would drive energy company behaviour to secure the right outcomes. Fig 2. provides an example of how this could work.

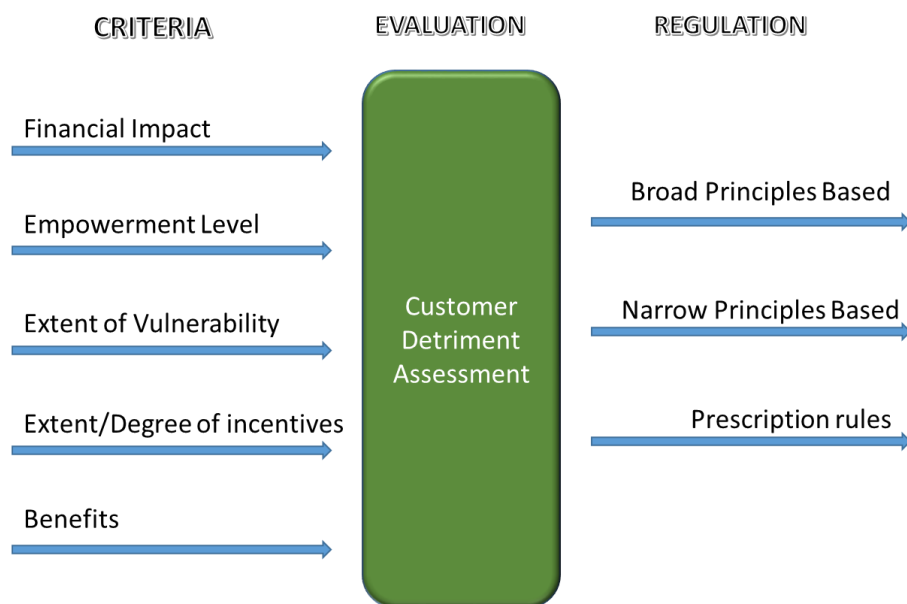


Fig.2: Sample criteria for evaluating the regulatory approach

² Consumer engagement and Detriment Survey, <https://www.gov.uk/government/publications/consumer-engagement-and-detriment-survey-2014>, accessed 4th March 2016.

CHAPTER 5: MANAGING THE TRANSITION EFFECTIVELY

Question 13: How would you like to engage with us on our proposals and the broader work programme?

Gemserv supports the thrust of Ofgem’s work in this area. Please do let us know if we can input to your development work on the future direction to principle based regulation.

Our response has focused on the importance of establishing the right framework and methodology. We would be happy to meet with you to discuss how this work might be developed.

We could arrange for a part-time placement for one of our regulatory and governance experts to work directly with your team, or act as a sounding board as and when you need our input. In particular, we would be keen to explore further with you our suggested approach and ideas as outlined in this response.

Question 14: Do you agree with our proposal to take a phased, priority-driven approach to reforming the supply licences.

Gemserv supports a phased and priority driven approach, one that is informed on a risk-based methodology. However, the focus should be on how best to assess the candidate SLCs. This requires agreeing the framework and methodology before embarking on wholesale reform. Candidate SLCs should be critically assessed and our recommended approach would be to:

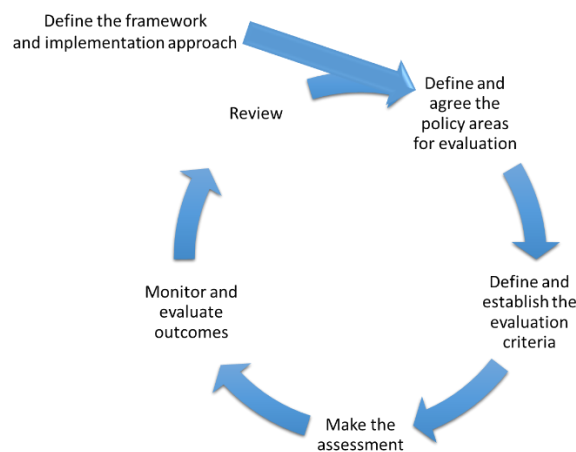


Fig.3 Principle based assessment cycle

With regard to timing, we note that principle-based regulation increases the compliance challenge for Ofgem. Inevitably, the principle-based approach will lead to many energy company variants in terms of how regulatory compliance is to be met. It is quite possible there will be a trade-off between lessening the burden for energy companies vs the increased compliance monitoring and assessment burden for Ofgem. It will be important to ensure that consumers are not harmed while compliance plays catch up to the raft of new practices that will evolve. For these reasons, we agree with Ofgem that a phased approach based on agreed priority areas will allow adjustments to be made: behaviourally by energy companies and for Ofgem to equally adjust its methods.