



9 March 2016

**The future of retail market regulation
Response to Ofgem Consultation by Professor Christopher Hodges**

General

I would like to firmly commend Ofgem's general thinking and direction of travel as set out in this consultation paper. Indeed, I would urge Ofgem to develop it further, as discussed below. I suggest that the switch to a principles-based approach is correct, and should bring many benefits, as outlined in the consultation, but that such a move will necessitate further changes than are currently contemplated in the paper if the approach is to be consistent and successfully achieved.

My basic proposition is that the approach should be firmly grounded on fundamental ethical principles, and, if that is done, various incentives, supports, impediments and barriers need to be addressed. An important exercise is to consider how the objective is to be achieved, in practice, from firms' perspectives: what should they actually do? Further, should existing approaches and the internal organisation structure of Ofgem be reviewed?

The viewpoint from which I comment on the proposals is based on my recent extensive research into regulatory enforcement policy, practice and theory. The detailed substantiation and analysis are set out in a large recent book.¹ A short version of the ideas on how the findings of behavioural psychology can be extrapolated from into the design of a regulatory and enforcement system so as to support Ethical Business Practice has recently been published by the Department for Business Innovation & Skills.²

The following comments will not deal seriatim with all the questions in your Consultation paper. Instead, I will focus on what seem to me to be some basic points; I generally agree with the direction of travel of almost all of the detailed questions that you raise, and will not comment on them here.

What are the right principles?

Adopting a principles-based approach to regulation begs the question 'What principles should be applied?' The basic principle that Ofgem is applying is the recent

¹ C Hodges, *Law and Corporate Behaviour: Integrating Theories of Regulation and Enforcement* (Hart Publishing, 2015).

² C Hodges, *Ethical Business Regulation: Understanding the Evidence* (Department for Business Innovation & Skills, Better Regulation Delivery Office, 2016), at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/497539/16-113-ethical-business-regulation.pdf

Standard of Conduct included in the Licence Conditions³ that suppliers should ‘treat customers fairly’, supplemented by some subsidiary principles.

I strongly commend the ‘treating customer fairly’ policy. However, I suggest two points here. First, there is a more fundamental applicable principle that ought to be applied than (just) treating customers fairly, namely that that firms should be ethical (do the right thing) in *everything* that they do. Second, *firms* would be assisted in achieving greater compliance, and wider social and market benefits would be achieved, if that more fundamental principle were to be adopted on a holistic basis throughout a business.

The Consultation has noted what I consider to be a wider shift towards ethical regulation in the UK, kindly referencing my recent book, noted above. That book set out the scientific evidence for founding a regulatory, compliance and performance system on an ethical and holistic basis. Since that book was published, BRDO has published a concise summary of the arguments in relation to the holistic concept of Ethical Business Practice (EBP).⁴ In short, the proposition is that ethical values should be at the basis of *all* activities of traders, consumers and regulators, and efforts to achieve minimum standards as well as drive constant improvements in performance should be based on a collaborative approach, involving constant monitoring, feedback, evaluation, learning and application.

Accordingly, smart regulation should be based on principle(s), but a principle of behaving ethically in every respect is more fundamental than one of treating customers fairly. Treating customers fairly is, of course, a valid and essential principle, one that should apply in relation to the activities of energy companies (and other companies, and it has been adopted in various other regulatory and consumer law regimes), but it is itself subsidiary to a principle of behaving ethically. Those two principles are wholly consistent.

I fully agree with the statement in the Consultation:

‘Culture change is critical to getting the transition in this area right. Suppliers and Ofgem must work towards a closer relationship with one another.’⁵

As products of that culture, one would wish to see closer discussions, sharing information, and early discussions.

There is strong support from behavioural science to support the proposition that if a firm has a culture of behaving ethically in all its activities, then its staff are likely to find it easier to treat customers fairly. Merely trying to treat customers fairly may conflict with other goals, incentives and behaviours, such as a desire to achieve targets, to reduce costs, to keep one’s job, to maintain profitability, to maximise shareholder value, and so on. If *all* relevant actions are subject to the overarching principle of behaving ethically, then the tension between various drivers can be identified and faced, which should tend to promote a culture of honest recognition of conflicting goals and of resolving them by making ethical decisions. The objective of

³ 25C.2 and 25C/4, at <https://epr.ofgem.gov.uk/Content/Documents/Electricity%20Supply%20Standard%20Licence%20Conditions%20Consolidated%20-%20Current%20Version.pdf>

⁴ See fn 2 above.

⁵ para 3.14.

basing decisions on a principle that applies to all of a firm's activities is that it can pervade all the activities of a company, permeating its internal culture, rather than merely being applied externally as part of one particular regulatory requirement. All firms face numerous external regulatory requirements (corporate, financial, environmental, workplace health and safety, food safety, corruption, competition, product research and development, marketing, and so on). It would seem to be likely to enhance compliance with each separate external regime if the same approach were to be taken towards each, rather than proliferate multiple individual requirements that may confuse.

It may be argued that a principle that is applied in any single regulatory regime, such as that of treating customers fairly, is legally speaking the fundamental requirement of that given regime, since it is (usually) established under the relevant sectoral regulatory law. In other words, a generic principle of ethical business conduct might not legally be mandated or mandatable under a particular legal regime. One answer to that would be to move towards changing the legal requirements. But even without such a move, it would seem to be possible to proceed on the basis of observance of such an overriding principle. First, individual firms could voluntarily adopt the overarching principle. Second, regulators could take that overarching principle into account as the guiding ethical principle against which particular subsidiary principles and rules were to be applied. Third, regulators could also take the overarching principle into account in considering enforcement action, as many already do to some extent.

I would urge Ofgem to work towards establishing a general principle of EBP as the fundamental requirement, when possible to do so, and whether through voluntary agreement, inclusion in guidance, or under law. In addition, below that overarching principle as it were, other principles such as treating customers fairly could continue to apply.

In that connection, I agree with the four subsidiary principles identified in the Consultation, namely:

- Constructive engagement with the regulator
- Good record-keeping
- Board-level assurance around embedding of principles
- Not putting consumer outcomes at risk

In addition, subsidiary principles could be added based on aspects of a systemic approach (discussed further below), such as to support systemic and actual feedback, learning, acting responsibly, acting openly, and making redress when due. But, in any event, is it not easier for both firms and the regulatory community generally to build all of these subsidiary principles into an overarching principle of Ethical Business Practice?

What is ethical or fair?

In implementing a general principle of behaving 'ethically' or 'fairly' the question arises of what constitutes compliance—or breach? Ethical values can differ between societies, and over time. The ethical values that should be applied in evaluating

specific behaviour should be those of the society, or state, in which the behaviour takes place.

There can be a legal requirement to behave fairly, but deciding what is fair is not necessarily a task (exclusively or otherwise) for a lawyer or judge. Public reaction to issues such as MPs' expenses, levels of bonuses paid to bankers, low levels of payment of tax by multinationals, and so on, clearly demonstrate that whilst particular conduct may be legal it may not be viewed as fair by a society.

The Consultation is right that there will need to be a fundamental rethink of the rulebook, the content of obligations in licences, and the role of guidance. But I think that a rethink needs to be more fundamental than might currently be envisaged.

Decisions on what constitutes fairness are increasingly decided in UK by consumer ombudsmen. This evolution has occurred as the statutory or scheme rules under which ombudsmen operate have increasingly been based on deciding consumer complaints against firms not just on the basis of applying legal rights but also on the basis of what, in the ombudsman's opinion, is 'fair and reasonable in the circumstances'.⁶

If a regulatory regime switches from a rules-based approach to a principles-based approach, and specifically involving principles of ethical values and fairness, who should decide what is fair? Should a relevant ombudsman be the only arbiter? The developing suggestions behind the concept of Ethical Business Practice that I am putting forward as a holistic approach to all business regulation include arrangements under which the fairness of activities and decisions can be constantly checked by people at all levels within an organisation, with other individuals who may be both internal and external to the organisation, not least consumers, customers and suppliers. It seems rational that important decisions, such as those that involve balancing conflicting principles or goals (including staying in business), should be taken on the basis of senior responsible managers with, ideally if time permits, the benefit of consultation with people whose ethical judgment is trusted. Arrangements for consultation may, therefore, be needed with an ethics committee, the ombudsman, all stakeholders (investors, commentators, consumers, customers, suppliers, staff), and with a regulator. I suggest that it is in this context that one should approach the strong proposal of Ofgem in the Consultation that firms should discuss issues with it, and do so openly and at an early stage.

Compliance and enforcement

I suggest that some inconsistency remains in the area of what is meant by 'enforcement', and I urge Ofgem to consider the issues further. The basic problem arises because of what I suggest is a hang-over from the traditional approach to enforcement, namely a policy based on deterrence, and the fact that in switching to an approach based on (ethical or fairness) principles and closer collaboration, there is an inherent residual inconsistency that needs to be resolved.

⁶ Note that this approach is not the same as that of ombudsmen deciding citizens' complaints against state entities, where the traditional criterion is 'maladministration'.

The issue on ‘enforcement’ is partly linguistic, partly conceptual, and partly bureaucratic. The traditional idea is that once a breach of a legal requirement has been identified, the matter will be handed over to the ‘enforcement department’, who will take ‘enforcement action’, achieve perfect ‘deterrence’, and both the sanctioned trader and all others will in future behave in perfect compliance. Not many people who have practical experience of business or regulatory systems believe that that paradigm occurs these days. I suggest that we need to adopt a more realistic and practical understanding of why people break rules, and how they can be assisted to make the right decisions, and to put things right when they go wrong. That approach is firmly based on the research noted above that I have done across many regulatory and business compliance systems in different sectors, and it accords with the government’s often-stated policy that ‘most people try to do the right thing most of the time’, and we should aim to support such behaviour rather than undermine it.⁷

The Consultation refers several times to deterrence. The word ‘deterrence’ is confusing, as it carries several possible connotations. At bottom, what seems to be meant is a means of affecting future behaviour, so that non-compliance is ‘deterred’, and hence compliance is achieved. However, there are real difficulties with that view. My understanding of the state of scientific research is that the brains of some individuals can usually be affected so that they refrain from doing something if they perceive there to be a high risk that they will be identified if they do it. The size of the potential penalty does not seem to be particularly relevant. However, if one wishes to affect behaviour through deterrence, three broad problems arise. First, many human decisions are not based on rationality, especially in evaluating the risks and benefits that may flow. Humans make poor or wrong decisions for all sorts of reasons, and fear of adverse consequences may have little or no effect. Second, there may be considerable difficulties in achieving a widespread perception that particular behaviour will be identified and will lead to a high likelihood of imposition of adverse consequences. Obvious problems arise of limitations on resources, costs, and the sheer breadth of potential activities that need to be monitored and prosecuted. Third, in a modern democracy, it is constitutionally unacceptable to aim to affect the behaviour of citizens by a systemic policy of inducing fear in citizens. That approach would be expected in totalitarian dictatorships. In a democracy, it is more acceptable and, behavioural psychology seems to suggest, more effective, to build positive ethical supportive mechanisms.

Accordingly, any enforcement policy that is based on ‘credible deterrence’, as is stated by Ofgem and one or two other authorities (but in fact only by a minority) simply cannot be credible, since it is bound to fail in preventing future non-compliance. A regulator who adopts such a policy does not deserve respect. Whilst it is possible to affect future behaviour through deterring it in some circumstances, it is not credible to base a compliance policy on ‘deterrence’ alone, or with deterrence as a major part. I suggest that it is better to avoid the word ‘deterrence’ and talk instead about ‘affecting future behaviour’ or ‘performance’.

⁷ *A Fair Deal for All. Extending Competitive Markets: Empowered Consumers, Successful Business* (Department for Trade and Industry, 2005); *How Your Business Can Achieve Compliance. Guidance* (Office of Fair Trading, 2010), OFT1278, October 2010; *Statement of consumer protection enforcement principles* (Office of Fair Trading, 2010), OFT1221, revised 2012; *A better deal: boosting competition to bring down bills for families and firms* (HM Treasury, December 2015), Cm 9164.

I agree that it is not necessary or appropriate to place personal accountability on senior executives by means of criminal responsibility for the activities of their firm, its system, its culture or its entire staff.⁸ I do not think that moves in that direction under regimes in financial services and the criminally-backed duty of candour in the NHS have grasped the unethical basis and harmful effects of such an approach.

I strongly suggest that there is a serious risk of sending inconsistent signals that would put off suppliers from sharing information. It is confusing to regulatees to receive messages that mix 'we will help you' and 'we will sanction you' without greater understanding that these two approaches are reserved for different types of people and cultures. Such inconsistency does not build a culture of openness, collaboration, compliance, learning or trust. The critical issue is the approach to enforcement. For most people and firms, the approach has to be on fostering a 'no blame' culture, otherwise people will simply not openly volunteer full essential information. The Consultation includes various references to concerns voiced by suppliers over Ofgem's approach, and I suggest that these need to be considered seriously. Paragraphs 3.16-17 in the Consultation send conflicting messages by mixing a traditional deterrence approach with a more modern learning cultural approach. This is a serious issue. I would confidently predict that unless these inconsistencies are resolved, the whole approach as currently proposed by Ofgem will fail, and degenerate into relationship characterised by mistrust, not sharing information, and not collaborative.

Is a change in the internal architecture needed?

The Consultation refers in 'Operating the framework' to the 'stages' that Ofgem operates as being 'engagement, monitoring, compliance and enforcement'.⁹ The Consultation also gives the following definitions of those four 'stages':¹⁰

'engagement' primarily covers helping suppliers understand their obligations.

'monitoring' covers collecting data and information to understand what is happening in the market.

'compliance' is the work we do with suppliers to resolve problems that have been identified.

'our vision for enforcement is 'to achieve a culture where businesses put energy customers first and act in line with their obligations'

It may be relevant that 'enforcement' is not actually defined: what is given instead is 'our vision' of what enforcement is intended to achieve. I suggest that what you have stated as that vision is absolutely correct, but it is not a vision of enforcement, or one that could practically be achieved by what most people understand 'enforcement' to be.

For exactly the same reasons as noted above in relation to 'deterrence', I do not think that you can affect culture by what we traditionally understand as enforcement. In any event, the word 'enforcement' is not terribly helpful in a principles-based

⁸ para 2.45.

⁹ para 1.23.

¹⁰ paras 3.7-3.8 and 4.2-4.3.

environment. Its basic meaning is the application of public sanctions, such as prosecuting, fining, imposing redress orders, undertakings and so on. As a preliminary stage, it may traditionally involve formal investigation. However, in a collaborative relationship, formal investigation may be far less relevant or required. All of the above enforcement activities are, of course, required elements of a regulatory authority. But they do not, by themselves, come anywhere near achieving behaviour change or change in culture of regulated businesses or their human personnel. The Consultation refers to achieving a *culture* within firms that will produce maximum compliance. The fundamental importance of that goal is, I fully accept, absolutely correct. But I am not aware of any scientific evidence that imposing sanctions is capable of achieving an ethical culture or behaviour change on the part of the people sanctioned—it often produces resentment.

Similarly, I question whether the proposal that ‘We will make it easier for all suppliers to learn lessons from enforcement actions’ is quite right. Encouraging the learning of lessons should be a *continuous* requirement of supervision and, where appropriate, of formal action.

Consequential Administrative Structures

Are the four stages the right ones to achieve the goal of adherence to a principles-based regulatory system? What are the bureaucratic organisational functions and arrangements that should be in place to achieve such a goal? I do not find the distinction between ‘compliance’ and ‘enforcement’ as separate stages to be particularly helpful. Does this merely reflect the current administrative separation within Ofgem into different divisions?

I suggest that the essential focus of regulation and enforcement should be on the best effective ways to support *firms* and the *people* who work in them in how *they* build their internal cultures in ways that external society finds desirable. Surely the purpose of regulation (as a whole) should be based on EBP, and achieving a culture that achieves EBP. It should not, surely, be on achieving a culture of ‘enforcement’. For some people whose motives or actions are plainly unacceptable, a punitive response that is fair, proportionate and protective of society is justified. But for most people and organisations, the general approach of UK regulators and government is clearly now based on support, advice and education, rather than deterrence. The goal and the process are therefore essentially holistic.

I suggest, therefore, that it is no longer helpful to regard ‘engagement, monitoring, compliance and enforcement’ as separate functions, and to divide them into separate formal ‘stages’, involving an idea of transfer or escalation to ‘enforcement’. Your Consultation rightly says that ‘In practice, both engagement and monitoring interact with compliance and enforcement.’¹¹

I therefore urge further thought about how important information on improving performance, and avoiding risks, can be conveyed to and agreed by individual firms and suppliers generally.

¹¹ para 1.34.

Surely it is a requirement in all cases worth discussion between a regulator and a firm that the starting point is that all the relevant and true facts are known, and hence all relevant facts are able to be considered so as to identify the cause of the potential risk of non-compliance, and how it might be avoided by any firm in future. In other words, *investigation* is a requirement in every case, although it might be satisfactorily be carried out to a greater or lesser extent by firms' internal staff if they are sufficiently trusted, expert and resourced.

I suggest that a more helpful way of categorising the response to problems would be to talk of achieving acceptable behaviour and making redress (or rectification). In what I consider to be the most thoughtful regulatory regimes, language of 'compliance' has evolved to that of 'culture' and 'performance'. This evolution signifies recognition that individual instances of breaking a rule (non-compliance) are less important in a complex and multi-dimensional risk-based world than the goal of constant improvement in reducing the risk of non-compliance (focusing therefore on the most serious risks as a priority, but encompassing all risks wherever possible) and constantly improving performance in compliance.

The next issue that arises is whether the functions, and the internal departments within Ofgem, should in fact be reordered, as an inevitable consequence of adopting a principles-based approach, so that the essential functions are delivered more seamlessly. I am aware of instances in more than one regulatory authority in which actions taken by different departments (especially compliance/supervision and enforcement) have sent different and conflicting messages to firms, and have not supported the targets' ability to operate on an ethical basis. The issue is how to achieve a holistic and consistent regulatory approach to behaviour. Is it still relevant that there be a formal step of 'opening an investigation' and announcing that an enforcement action has been started or completed? Is such a step required in most cases? (I accept that it may be required in some instances of serious wrongdoing, in which the firms are not collaborating with the authority.) Would it be simpler and more effective if changes were encouraged to be agreed informally in most cases? I support the ability of an authority to have powers to investigate facts, but that power should ideally be used only rarely.

A holistic approach to supporting a culture based on ethical principles necessarily involves a constant learning cycle. This includes a constant cycle of functions such as monitoring, checking, collecting data, analysis, learning, feedback, deciding on change, applying change, rectifying problems, checking the effects of change. If that is right, what are the consequences for the internal organisation within a regulator?

Maximising Data

The strategy rests on maximising the information from consumers. I fully agree that the Consultation is right in identifying OS:Energy as 'in a good position to identify systemic issues causing poor consumer outcomes and to share such findings with suppliers and Ofgem'.¹² I suggest that there is potential for confusion by consumers

¹² Para 2.34.

between OS:E and Citizens Advice, and a risk of failure to achieve maximal consumer feedback of critical data. I am unclear what role is envisaged for CA, and whether it this potential duplication and confusion will be effective in monitoring the market.

Ethical Sanctioning

How should sanctions be triggered or imposed under a principles-based regime? What should the response be to acting unethically or unfairly? Some important rethinking is necessary here.

The traditional approach is that sanctions may be imposed for breach of a rule. Under a principles-based regime, there will still be non-compliance with *rules* in some circumstances. Accordingly, that may justify a formal response by the public authority, traditionally called ‘enforcement’, which publicly marks the breach of the rule, and possibly imposes some sanction.

But the fundamental point is to be able to respond to breach of a *principle*, such as unethical/unfair practice, or not treating customers fairly. Will breach of an ethical principle always constitute breach of a rule? Should it? And what should trigger a regulatory response?

Further, what should be a fair response? It seems (ethically) right that response should be based on an ethical response to unethical behaviour (rather than responding to breach of individual rules). There should be an emphasis on learning, being honest, owning up (responsibility), applying the lessons to reduce the risk of future non-compliance, and putting damage right. Hence, penalties should incentivise those ethical behaviours, not constitute barriers to people adopting those behaviours,

I suggest that the size of the harm created by a breach¹³ should *not* be a factor taken into account in imposing a sanction. The correct response to causing harm, where there has been a breach of particular rules, should be to rectify the situation (repair the environmental damage, pay redress, and so on), rather than impose a punitive sanction just because harm has been caused, or a large amount of harm has been caused. Redress is essentially a civil matter not a criminal matter. Retention of profits from wrongdoing should be viewed as a residual public issue. The primary responsibility should be to repair the harm caused, and if any profits have been retained over and above the sums paid in making redress, they should not be retained. The responsibility to oversee such wrongful retention should primarily be the public official, not the private party who has been harmed. Where a firm has benefitted from the wrongdoing of one or more of its employees, the responsibility for the behaviour and redress is that of the employee. The firm should be responsible for any failure to have or operate satisfactorily an appropriate oversight system. It should also repay, as a matter of unjust enrichment, any benefits that it has gained from the wrongdoing by its employee. But the firm would not have criminal responsibility as if it had committed the employee’s wrongdoing itself.

¹³ See first bullet on page 37 (evidence of significant harm), although this point is raised in a different context .

I hope the above comments are helpful. Notwithstanding having raised some critical issues, I repeat that the general thrust of the thinking in the Consultation strikes me a firmly in the right direction: I would just encourage a little more movement, since I think it would significantly assist achieving Ofgem's goals.

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