

August 2000

**Utilities Act
Financial Penalties**

Executive summary

Under the Utilities Act 2000 (“the Utilities Act”) the Gas and Electricity Markets Authority (“the Authority”) will be able to impose financial penalties on licence holders. These financial penalty powers, laid out in sections 59 and 95 of the Utilities Act, allow the Authority to impose a penalty on licensees who contravene (or have in the past contravened) any relevant condition or requirement or who are failing (or have in the past failed) to achieve any individual standard of performance. Any penalty imposed must be reasonable in all the circumstances of the case and may not exceed more than 10% of the licensee’s turnover and must be in accordance with the procedural requirements laid out in the Utilities Act.

These powers to impose penalties on licensees are in addition to the licence enforcement powers held by the Directors General of Gas and Electricity Supply (which will be transferred to the Authority under the Utilities Act) and are in addition to the Director/Authority’s powers under the Competition Act 1998. However, the Authority is prevented from imposing a Utilities Act financial penalty if it is satisfied that the most appropriate way of proceeding is under the Competition Act 1998.

The Utilities Act requires that the Authority prepares and publishes a statement of policy, on the imposition of financial penalties and the determination of their amount, to which the Authority must have regard when deciding whether to impose a penalty. This consultation paper sets out the relevant issues that the Authority might wish to consider when deciding whether to impose a Utilities Act financial penalty and the level of any such penalty.

A number of factors may have relevance to whether it would be appropriate for the Authority to impose a financial penalty:

- ◆ compatibility of the imposition of a penalty with the Authority’s principal objective to protect the interests of consumers, and other statutory duties, such as the duty to ensure that licence holders are able to finance their licensable activities;
- ◆ the need to incentivise the licensee’s compliance and to deter the licensee or other licensees from further contraventions or failures;
- ◆ whether the contravention/failure had damaged consumers and/or market participants, for example by increasing costs;

- ◆ whether any gain (financial or otherwise) had been made by the licensee; and
- ◆ other factors including the duration and extent of the contravention or failure.

In calculating the level of the proposed penalty, a number of factors may be taken into account, including:

- ◆ the seriousness of the contravention or failure;
- ◆ the harm or increased costs that the contravention or failure has caused to consumers and/or market participants;
- ◆ any gain (financial or otherwise) made by the licensee as a result of the contravention or failure;
- ◆ the need to make any adjustments for:
 - increases due to aggravating factors such as, repeated contraventions or failures, involvement of senior management, concealment of activities; and
 - decreases due to mitigating factors such as, taking steps to remedy the contravention or failure and ensure compliance, and the licensee's co-operation with the Authority during the investigation.

This consultation paper also sets out how the Authority's financial penalty powers will operate with the existing enforcement process and the Competition Act 1998. It also invites views on the issues raised.

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1. Introduction

Purpose of this document

- 1.1 The Utilities Act 2000 ("the Utilities Act"), which has just received Royal Assent, contains provisions for the imposition of financial penalties.
- 1.2 Sections 59 and 95 of the Utilities Act ("sections 59 and 95") provide in electricity and gas respectively for the Gas and Electricity Markets Authority (the Authority), established under section 1 of the Utilities Act to impose a financial penalty on a licence holder "of such amount as is reasonable in all the circumstances of the case", but subject to a limit of 10% of the turnover of the licensee (such turnover to be determined in accordance with an order to be made by the Secretary of State). The Authority may not impose a financial penalty if it is satisfied that the most appropriate way of proceeding is under the Competition Act 1998. Such penalties can be imposed where the Authority is satisfied that a licence holder has contravened or is contravening any relevant condition or requirement; or has failed or is failing to achieve any standard of performance prescribed under section 39 or 39A of the Electricity Act 1989 or under section 33A or 33AA of the Gas Act 1986. In addition, sections 59 and 95 set out requirements for the provision of various notices, timescales for payment, consideration of any representations or objections, interest payments and the licensee's right to make application to the court.
- 1.3 Sections 59 and 95 require the Authority to prepare and publish a statement of policy with respect to the imposition of penalties and the determination of their amount. In deciding whether to impose a penalty, and in determining the amount of any penalty, the Authority is required to have regard to its statement of policy. The Authority can revise its statement of policy and publish any revised statement. The Act also provides that the Authority shall undertake such consultation as it considers appropriate when preparing or revising its statement of policy.
- 1.4 This paper sets out Ofgem's initial views on its policy on the imposition of penalties, under both sections 59 and 95 of the Utilities Act, and the determination of their amount. Whilst this consultation is not the consultation of

the Authority, it is likely that the Authority will take into account the representations and objections received under this consultation.

Structure of this document

- 1.5 Chapter 2 outlines the statutory powers Ofgem has to take action against companies in respect of contraventions and failures. Chapter 3 sets out the circumstances in which financial penalties might be applied and the processes involved. Chapter 4 explains how financial penalties might be calculated. Chapter 5 summarises the points on which views are invited and sets out the next steps.
- 1.6 **Please note that section 1 of the Utilities Act will, on commencement of that section, abolish the offices of the Director General of Electricity Supply (DGES) and the Director General of Gas Supply (DGGs). The duties and powers of the DGES and the DGGs outlined in the text of this paper will transfer to the new Authority established under the Utilities Act. Therefore all references in this paper to the DGES and/or the DGGs should be read as meaning, in the future, the Authority.**

Contact details

- 1.7 Comments are invited on the proposals contained in this paper. Responses should be sent, by **Friday 29 September 2000**, to:

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- 1.8 Responses will be published by placing them in the Ofgem library unless they are clearly marked "Confidential – Not for Publication". If you have any questions concerning this document, Lisa Vango on 020-7932-5178 or Arthur Cooke on 020-7932-5897 will be pleased to help.

2. Statutory Powers

- 2.1 Ofgem has a number of powers to take action against companies in respect of licence breach and failure to meet standards of performance and other obligations. These powers will continue, although slightly amended by the Utilities Act. In addition, Ofgem has concurrent powers with the Director General of Fair Trading (DGFT) in respect of the application of the Competition Act 1998 to electricity and gas. As explained in paragraph 1.6, the enforcement duties of the Director General of Electricity Supply (DGES) and the Director General of Gas Supply (DGGS) will be transferred to the Authority. Therefore, references to the DGES or the DGGS should be read as meaning in future the Authority.

The Electricity Act 1989 and the Gas Act 1986

i) Enforcement action

- 2.2 Section 25 of the Electricity Act 1989 (“the Electricity Act”) requires the DGES to make final orders (or confirm provisional orders), where he is satisfied that a licence holder is contravening, or is likely to contravene, any relevant condition or requirement, for the purpose of securing compliance with the relevant condition or requirement¹. The DGES, in determining whether to make a provisional order is required to have regard to the extent to which any person is likely to sustain loss or damage in consequence of anything which is likely to be done, or omitted to be done, before a final order could be made. The DGES cannot make a final order (or confirm a provisional order) if he is satisfied that the licence holder has agreed to take and is taking all such steps as it appears appropriate to take to secure compliance with the relevant condition or requirement, or if he is satisfied that the contraventions were or are of a trivial nature². The DGES can make a final order whether the contravention was

¹ The DGES shall, if it appears that a licence holder is contravening or is likely to contravene a relevant condition or requirement, make a provisional order under section 25 of the Electricity Act 1989.

² The DGES must also take into account other considerations in determining whether to make a final order (or confirm a provisional order) such as the compatibility of his actions with his statutory duties and the appropriateness of using his Electricity Act powers, as opposed to his Competition Act 1998 powers.

intentional or not. The DGES only has to be satisfied that a contravention or failure has occurred³.

- 2.3 Section 28 of the Gas Act 1986 (the Gas Act) contains equivalent provisions in relation to gas, requiring the DGGS to make final orders (or confirm provisional orders), where he is satisfied that a licence holder is contravening, or is likely to contravene, any relevant condition or requirement, for the purpose of securing compliance with the relevant condition or requirement. Section 28 also allows the DGGS, in making a final order, to require the licence holder to pay a monetary penalty. However, this power to impose a monetary penalty has been repealed under the Utilities Act.
- 2.4 A “relevant condition” is currently defined in section 25 of the Electricity Act (in relation to electricity) as any condition of the licence holder’s licence. A “relevant requirement” is defined as any duty or other requirement imposed on the licensee by or under section 9 or sections 16 to 23 (as amended by the Utilities Act)⁴. These sections, as amended by the Utilities Act, include: a duty on holders of an electricity distribution licence to develop and maintain an efficient, co-ordinated and economical system of electricity distribution and to facilitate competition in the supply and generation of electricity (section 9(1)); and the making and maintaining of a connection (section 16).
- 2.5 The Utilities Act expands the current definition of a “relevant requirement” contained in section 25 of the Electricity Act to encapsulate: the environmental obligations of licensees, such as electricity from renewable sources (section 32 of the Electricity Act); overall standards of performance for electricity suppliers and electricity distributors (sections 40 and 40A of the Electricity Act); and help for disadvantaged groups of customers (section 43A). A list of those sections of the Electricity Act, which are relevant requirements under section 25 (as amended by the Utilities Act) is attached to this paper, as Annex A.
- 2.6 The definition of a “relevant condition” in relation to gas, is contained in section 28 of the Gas Act, and mirrors the definition contained in section 25 of the

³ In making any such final or provisional order, the DGES (and the DGGS in relation to gas) must comply with the procedural requirements laid out in sections 25 to 27 of the Electricity Act 1989 (or in relation to gas, sections 28 to 30 of the Gas Act 1986).

⁴ Sections 16 to 23 of the Electricity Act, as amended by the Utilities Act, relate to an application for connection to a distribution system (following the introduction of supply and distribution as separate licensable activities under the Utilities Act).

Electricity Act. A “relevant requirement” under section 28 is defined as “any requirement imposed on him [the licensee] by or under” certain sections of the Act. Section 28 then lists those sections which are taken to be relevant requirements. The list includes: a duty on gas transporters to develop and maintain an efficient and economical pipe-line system for the conveyance of gas (section 9); a duty on gas transporters to connect certain premises (section 10); overall standards of performance (section 33B); and the maintenance, repair and renewal of service pipes (Schedule 2B, paragraph 15).

- 2.7 The Utilities Act expands the current definition of a “relevant requirement” contained in section 28 of the Gas Act to include: overall standards of performance for gas transporters (section 33BA); and help for disadvantaged groups of customers (section 41A). A list of those sections of the Gas Act, which are relevant requirements under section 28 (as amended by the Utilities Act) is attached to this paper, as Annex B.

ii) Standards of performance (overall and individual)

- 2.8 Section 39 of the Electricity Act provides for the DGES, with the consent of the Secretary of State, to make regulations prescribing certain standards of performance that licence holders should meet in respect of individual cases (i.e. guaranteed standards). Under these Regulations, licence holders are required to meet certain standards of performance and to pay compensation for any failure to meet the prescribed standards. For example, an electricity supplier is required to pay compensation for a failure to restore supply following an unplanned outage⁵. The current regulations⁶ provide for individual domestic customers to be paid £40 (£100 for non-domestic customers) if their electricity supply is not restored within 24 hours (with an additional £20 for each further 12 hour period that they remain without supply)⁷. Sections 55 to 59 and 90 to 95 of the Utilities Act will amend the existing provisions relating to standards of performance. Consultation on revised standards of performance will take place in due course.

⁵ The Electricity (Standards of Performance)(Amendment) Regulations 1998 (Regulation 4)

⁶ The Electricity (Standards of Performance)(Amendment) Regulations 1998

⁷ However, compensation will not be paid if one of the exemptions outlined in the Regulations applies. For example, in relation to an unplanned outage due to an electrical storm the 24 hour period would not begin to run until it has been declared safe for engineers to address the outage.

- 2.9 These standards of performance in individual cases exist in conjunction with the overall standards of performance which can be determined by the DGES under section 40 of the Electricity Act in connection with the provision of electricity supply services⁸.
- 2.10 Similar provisions to those outlined above for electricity exist in relation to gas. Section 33A of the Gas Act gives the DGGs the power to make regulations as to standards of performance in individual cases and under section 33B the DGGs may determine standards of overall performance in connection with the provision of gas supply services⁹. To date, no regulations have been made outlining standards of performance in individual cases in relation to gas. This is because British Gas Trading and all public gas transporters have licence conditions that require them to set standards of performance. Additionally, all domestic gas supply licence holders are required to have arrangements for meeting their stated obligations.
- 2.11 If a licence holder fails to achieve an overall standard of performance prescribed under section 40 (or section 40A which is inserted by the Utilities Act) of the Electricity Act or under section 33B (or section 33BA which is inserted by the Utilities Act) of the Gas Act, then enforcement action under section 25 of the Electricity Act or section 28 of the Gas Act can be taken against that licence holder¹⁰. However no enforcement action can be taken against the licence holder in respect of a failure to achieve an individual standard of performance prescribed under section 39 (or section 39A which is inserted by the Utilities Act) of the Electricity Act, or under section 33A (or section 33AA which is inserted by the Utilities Act), as these sections are not "relevant requirements".

iii) Information gathering powers

- 2.12 All licences contain an obligation on licence holders to furnish information to the DGES (or the DGGs) when required to do so in connection with his functions under the Electricity Act (or the Gas Act).

⁸ The Utilities Act inserts section 40A of the Electricity Act which gives the Authority a further power to determine overall standards of performance for electricity distributors.

⁹ The Utilities Act inserts section 33BA of the Gas Act which gives the Authority a further power to determine overall standards of performance for gas transporters.

¹⁰ Sections 40 and 40A of the Electricity Act are defined as "relevant requirements" in section 25 of the Electricity Act (as amended by the Utilities Act). Similarly section 28 of the Gas Act (as amended by the Utilities Act) defines sections 33B and 33BA as "relevant requirements".

2.13 Section 28 of the Electricity Act allows that where it appears to the DGES that a licence holder is contravening or may have contravened any relevant requirement¹¹, the DGES may serve a notice requiring that any person, on whom he serves a notice, provide any information he specifies which are in that person's custody and to furnish such information specified and in the form and manner described, in the notice. Failure, without reasonable excuse, to furnish the DGES with such information may attract criminal liability. In addition to his powers under section 28, the DGES may, under section 42 of the Electricity Act collect information on a licence holder's performance against standards of overall performance and standards of performance in individual cases. Prior to the Utilities Act, a licence holder's failure to provide information requested by the DGES under section 42 of the Electricity Act may have attracted criminal liability. This criminal liability has been removed by the Utilities Act. However, under the Utilities Act, section 42 has become a "relevant requirement" within the meaning of section 25 and therefore enforcement action can be taken in respect of a failure to provide such information.

2.14 Section 38 of the Gas Act provides the DGGS with equivalent information gathering powers in gas, to those outlined above in relation to electricity¹². Failure, without reasonable excuse, to furnish the DGGS with such information attracts criminal liability. In addition, to his powers under section 38, the DGGS may, under section 33C of the Gas Act, collect information on a licence holder's performance against standards of overall performance and standards of performance in individual cases. As in electricity, under the Utilities Act, a licence holder's failure to provide information requested under section 33C may no longer attract criminal liability. However, under the Utilities Act, section 33C is deemed to be a "relevant requirement" within the meaning of section 28 of the Gas Act and therefore enforcement action can be taken in respect of a failure to provide such information.

¹¹ The Utilities Act expands the scope of section 28, allowing a notice to be served in relation to past contraventions and current or past failures to achieve any standard of performance in individual cases prescribed under sections 39 or 39A of the Electricity Act.

¹² Including, an expansion of the current information gathering powers to allow a notice to be served in relation to past contraventions and current or past failures to achieve any standard of performance in individual cases prescribed under sections 33A or 33AA of the Gas Act.

The Competition Act 1998

- 2.15 From 1 March 2000 the Director General of Gas and Electricity Supply (the Director) has had concurrent powers with the DGFT to undertake investigations and take action under the Competition Act 1998, in relation to the electricity and gas markets. The Act prohibits anti-competitive agreements (the Chapter I prohibition) and the abuse of a dominant position (the Chapter II prohibition). The Chapter I prohibition covers decisions by associations of undertakings and concerted practices, whether written or not. An agreement will infringe the Chapter I prohibition only if it has as its object or effect an appreciable restriction, distortion or prevention of competition in the UK. The DGFT takes the view that an agreement will generally have no appreciable effect on competition if the parties' combined share of the relevant market does not exceed 25%. However, this will not be the case where an agreement directly or indirectly fixes prices, imposes minimum resale prices or is one of a web of similar agreements which have a cumulative effect on the market.
- 2.16 For a breach of the Chapter II prohibition, an undertaking will have to be abusing a dominant position in an identifiable market. An undertaking will be considered dominant if it can behave to an appreciable extent independently of its competitors and customers when making commercial decisions in an identified market.
- 2.17 Concurrency arrangements¹³ seek to ensure that the regulators agree who should be handling any particular case and prevent two or more regulators considering the same conduct or agreement.
- 2.18 Section 36 of the Competition Act allows the DGFT, the DGES or the DGGS when acting on their sectoral powers under the Competition Act, to impose a financial penalty on a undertaking which has intentionally or negligently committed an infringement of the Chapter I or Chapter II prohibition. Any financial penalty imposed under the Competition Act may not exceed 10% of the "section 36(8) turnover" of a undertaking. The "section 36(8) turnover" of an undertaking for the purpose of this cap on penalties is calculated in accordance with the Competition Act 1998: Determination of Turnover for Penalties Order 2000, SI 2000 No, 309. The Office of Fair Trading's March 2000 publication

¹³ Laid out in Competition Act 1998: Concurrent Application to Regulated Industries (OFT 405).

“Director General of Fair Trading’s Guidance as to the Appropriate Amount of a Penalty” sets out a five step approach to the calculation of any penalty. The five steps are:

- ◆ calculation of the starting point by applying a percentage determined by the nature of the infringement to the “relevant turnover¹⁴” of the undertaking;
- ◆ adjustment for duration, for example the starting point may be increased to take into account the duration of the infringement;
- ◆ adjustments for other factors, for example in order to deter undertakings engaging in anti-competitive practices;
- ◆ adjustments for further aggravating or mitigating factors, for example aggravating factors include repeated infringements, continuing the infringement after the start of the investigation; mitigating factors include, co-operation, taking adequate steps to ensure compliance; and
- ◆ adjustment if the maximum penalty of 10% of the section 36(8) turnover of the undertaking is exceeded and to avoid double jeopardy.

2.19 The Director has an obligation under the Electricity and Gas Acts to take enforcement action when there is a breach of a licence condition. The Director also has functions and duties under the Electricity and Gas Acts which must inform all his Electricity and Gas Acts activities. The Competition Act, however, gives the Director a power, not an obligation to take action. The Competition Act removes the Director’s obligation under the Electricity and Gas Acts to take enforcement action where it would be more appropriate to use his Competition Act powers. The Competition Act also removes the Director’s Electricity and Gas Act functions and duties in relation to the Competition Act to ensure that concurrent application with the DGFT is on the same legal basis. This means that the Director will be bound by his Electricity and Gas Act functions and duties when taking licence enforcement action. When he is taking action under the Competition Act, the Director is not required to have regard to his Electricity

¹⁴ “Relevant Turnover” is the turnover of the undertaking in the relevant product market and relevant geographic market affected by the infringement in the last financial year.

and Gas Act functions, but he will be bound by the requirements of the Competition Act.

- 2.20 The Competition Act ensures that two regulators cannot take action under the Competition Act in respect of the same case¹⁵. The Competition Act also ensure that any one regulator does not have to take investigative action under both the Competition Act and a sector specific Act (such as the Electricity or Gas Act), although they are not prevented from doing so if they so wish. The Director will be able to proceed in the early stages of an investigation under either the Competition Act or Electricity and Gas Acts or under both, but decide later that one Act is most appropriate. The Director can also switch from action under one Act to action under the other if, during the investigation this seems most appropriate.

¹⁵ Competition Act 1998 Schedule 10 Paragraphs 10(5) and 12(5) amend sections 28 and 25 of the Gas Act and the Electricity Act respectively to prevent the DGES (or DGGS) from making a final order (or confirming a provisional order) if the most appropriate way of proceeding is under the Competition Act 1998.

3. Financial Penalties

3.1 The Utilities Act establishes the Authority and an independent Gas and Electricity Consumer Council (the Council). The Act gives the Authority a principal objective, in carrying out its functions, to protect the interests of consumers in relation to electricity conveyed by distribution systems and in relation to gas conveyed through pipes, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with the generation, transmission, distribution or supply of electricity so conveyed (or the shipping, transportation or supply of gas so conveyed).

3.2 The Authority will be required to carry out its functions in the manner which it considers is best calculated to further the principal objective, having regard to:

- ◆ the need to secure that all reasonable demands for electricity are met (or to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met); and
- ◆ the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under Part I of the Electricity Act (or the Gas Act) or the Utilities Act.

3.3 In performing that duty, the Authority is required to have regard to the interests of individuals:

- ◆ who are disabled or chronically sick;
- ◆ of pensionable age;
- ◆ with low incomes; and
- ◆ residing in rural areas;

but this is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.

3.4 The Authority may, in carrying out its Electricity Act functions, have regard to the interests of consumers in relation to gas, and in carrying out its Gas Act functions have regard to the interests of consumers in relation to electricity.

3.5 In addition, the Authority may have regard to the interests of consumers in relation to telecommunication services and water or sewerage services which are affected by the carrying out of the Authority's Electricity and Gas Act functions.

3.6 Subject to the requirements outlined in paragraph 3.2, the Secretary of State and the Authority shall carry out their respective functions under Part I of the Electricity Act (or Part I of the Gas Act) in the manner in which he or it considers is best calculated:

(a) to promote efficiency and economy on the part of the persons authorised by licences or exemptions to transmit, distribute or supply electricity and the efficient use of electricity conveyed by distribution systems (or, in relation to gas, persons authorised by licences or exemptions to carry on any activity, and the efficient use of gas conveyed through pipes) ;

(b) to protect the public from dangers arising from the generation, transmission, distribution or supply of electricity (or the conveyance of gas through pipes and from the use of gas conveyed through pipes);

(c) to secure a diverse and long-term energy supply,

and shall, in carrying out those functions, have regard to the effect on the environment of activities connected with the generation, transmission, distribution or supply of electricity (or the conveyance of gas through pipes).

3.7 The Act allows for a financial penalty to be imposed by the Authority where the Authority is satisfied that a licence holder has contravened or is contravening any relevant condition or requirement; or has failed or is failing to achieve any standard of performance (prescribed under specific sections of the Electricity and Gas Acts). The amount of any penalty should be reasonable in all the circumstances of the case, but must not exceed a limit of 10% of the turnover of the licensee. Such turnover will be determined in accordance with provisions specified in an order made by the Secretary of State (and approved by a positive resolution of both Houses of Parliament).

3.8 This gives rise to a number of points. First, what are the relevant conditions or requirements and standards of performance? Second, how will the Authority gather sufficient information to satisfy itself that a licence holder has contravened

or is contravening any relevant condition or requirement or failing to achieve any standard of performance? Third, how will the financial penalty powers be used with existing powers (for example to take enforcement action)? Fourth, how will the Authority determine whether a penalty is appropriate and, if it is, what amount is reasonable in all the circumstance of the case?

Relevant Conditions, Requirements and Standards

- 3.9 The definitions of a “relevant condition” and a “relevant requirement” contained in section 25 of the Electricity Act and section 28 of the Gas Act which were discussed in paragraphs 2.4 to 2.7 apply to the whole of Part I of their respective Acts. Therefore, the definitions laid out in section 25 of the Electricity Act and section 28 of the Gas Act apply to the financial penalty provisions discussed in this paper which are inserted into the Electricity Act and the Gas Act by the Utilities Act.
- 3.10 The financial penalties provisions contained in the Utilities Act provide for the Authority to impose a financial penalty in respect of a licence holder’s failure to achieve certain prescribed standards of performance in individual cases. As regards electricity, a licence holder could be liable to a financial penalty for having failed or for failing to achieve any of the standards of performance prescribed under sections 39 or 39A. Section 39 provides for the Authority to prescribe standards of performance in individual cases in relation to the activities of electricity suppliers, whereas section 39A provides for the Authority to prescribe standards of performance in individual cases in relation to the activities of electricity distributors.
- 3.11 In addition to standards of performance in individual cases, licence holders are required to achieve certain standards of overall performance which are prescribed under sections 40 and 40A of the Electricity Act. As sections 40 and 40A become “relevant requirements” under section 25 of the Electricity Act, the Authority may also impose a financial penalty for failing to achieve a standard of overall performance.
- 3.12 In gas, a licence holder could be liable to a financial penalty for having failed or for failing to achieve any of the standards of performance prescribed under sections 33A or 33AA of the Gas Act. Section 33A provides for the Authority to

prescribe standards of performance in individual cases in relation to the activities of gas suppliers, whereas section 33AA provides for the Authority to prescribe standards of performance in individual cases in relation to the activities of gas transporters.

- 3.13 In addition to standards of performance in individual cases, licence holders are required to achieve certain standards of overall performance which are prescribed under sections 33A and 33AA of the Gas Act. As sections 33A and 33AA become “relevant requirements” under section 28 of the Gas Act, the Authority may also impose a financial penalty for failing to achieve a standard of overall performance.

Information Gathering

- 3.14 All licences contain an obligation on licence holders to furnish information to the DGES (or the DGGs) when required to do so in connection with his functions under the Electricity Act (or the Gas Act).
- 3.15 In addition, the provisions of the Electricity Act and the Gas Act (as amended by the Utilities Act), allow the Authority to gather information from licensees and other persons in respect of a past or existing contravention of a relevant condition or requirement or a past or current failure to achieve an individual standard of performance. Sections 28 and 38 of the Electricity and Gas Acts respectively provide for the Authority to serve a notice indicating any information which it requires (provided that the information is in the holder’s custody) and allow the Authority to specify the form and manner in which the information is required. Failure, without reasonable excuse, to comply with a request for information from the Authority under section 28 of the Electricity Act or section 38 of the Gas Act may attract criminal liability.
- 3.16 Sections 42 and 33C of the Electricity and Gas Acts respectively provide for the Authority to require information from licence holders in respect of their performance against specified standards of overall performance and standards of performance in individual cases. If a licence holder fails to provide such information to the Authority, enforcement action under section 25 of the Electricity Act or section 28 of the Gas Act may be taken against the licence holder.

Financial Penalties and Enforcement

- 3.17 The Utilities Act allows the Authority to impose a financial penalty for contravention of a relevant condition or requirement or failure to achieve a relevant standard in addition to using licence enforcement powers. However, the imposition of a financial penalty is not restricted to circumstances where licence enforcement action is being taken. The Act provides for a penalty to be imposed in respect of past or existing contraventions or failures, whereas enforcement action can only be taken in respect of existing or future likely contraventions.
- 3.18 Ofgem anticipates that, for existing contraventions, financial penalties would generally be considered as part of the current enforcement process.
- 3.19 Under the current enforcement process set out in the Electricity and Gas Acts, (sections 25 and 28 respectively) the DGES and the DGGs will, if satisfied that the licence holder is contravening or is likely to contravene any relevant condition or requirement, make a final order for the purpose of securing compliance with that condition or requirement. Alternatively, if it appears to the DGES (or the DGGs) that the licence holder is contravening or is likely to contravene any relevant condition or requirement a provisional order may be made, under section 25 of the Electricity Act (or section 28 of the Gas Act). If, following an investigation the DGES (or the DGGs) is satisfied that such a contravention (or likely contravention) is occurring, they may confirm that provisional order.
- 3.20 Sections 26 of the Electricity Act and 29 of the Gas Act require that, before the DGES (or the DGGs) can make a final order, or confirm a provisional order, they must give notice. The notice will:
- ◆ state that the DGES (or the DGGs) proposes to make or confirm the order and setting out its effect;
 - ◆ set out the relevant condition or requirement in question;
 - ◆ specify the act or omissions which constitute or would constitute contravention; and

- ◆ specify the period (not less than 28 days¹⁶ from the date of publication of the notice) within which representations or objections with respect to the proposed order or confirmation may be made.
- 3.21 Any representations or objections received within the timescale specified in the notice must be duly considered by the DGES (or the DGGs). Under sections 26 of the Electricity Act and 29 of the Gas Act, notification of a proposed order shall be deemed to have been given by publishing the notice in a manner appropriate for bringing it to the attention of those persons likely to be affected by it and by providing the licensee with a copy.
- 3.22 Once the DGES (or the DGGs) has made a final order (or confirmed a provisional order) then the licensee may, if aggrieved by the order, make an application to the court under section 27 of the Electricity Act (or section 30 of the Gas Act). However, applications to the court may only be made if the licensee is questioning the validity of the order on one of two grounds:
- ◆ that the making or confirmation of the order was not within the powers contained in section 25 of the Electricity Act (or section 28 of the Gas Act); or
 - ◆ that any of the requirements laid out in sections 26 of the Electricity Act (or section 29 of the Gas Act) have not been complied with.
- 3.23 If the court is satisfied that the DGES (or the DGGs) exceeded the powers contained in sections 25 and 26 of the Electricity Act (or sections 28 and 29 of the Gas Act) the court may quash the order, or any provision of the order.
- 3.24 Obviously, if the Authority is considering whether to impose a financial penalty on a licence holder in respect of a past contravention or failure, the investigation would not be conducted in conjunction with the existing enforcement process, as enforcement action under section 25 of the Electricity Act (or section 28 of the Gas Act) cannot be taken with respect to past contraventions or failures. However, the information gathering powers laid out in section 28 of the Electricity Act (section 38 of the Gas Act) may continue to be used.

¹⁶ Under the Utilities Act, the minimum time for allowing representations or objections is reduced to 21 days.

- 3.25 Under sections 59 and 95, where no final or provisional order has been made in relation to a contravention or failure, the Authority may not impose a financial penalty once 12 months has elapsed since the contravention or failure took place. However, the Authority may still impose a financial penalty (if no such order was made) provided that the Authority has, within the 12 month period, served a notice on the licence holder of its proposed intention to impose a financial penalty. The notice must be served in accordance with the provisions laid down in sections 59 and 95 of the Utilities Act. Similarly, if the Authority, within the 12 month period, serves a notice under section 28 of the Electricity Act or section 38 of the Gas Act requesting that the licence holder furnishes the Authority with certain information, a financial penalty may still be imposed.
- 3.26 Once a final or provisional order has been made (under section 25 of the Electricity Act and section 28 of the Gas Act) the Authority will not be able to impose a financial penalty unless the notice proposing the imposition of the penalty is served on the licensee within 3 months from the making of a final order (or the confirmation of a provisional order). If a provisional order has been made but has not been confirmed then the Authority cannot impose a financial penalty unless the notice proposing the imposition of the penalty is served on the licensee within 6 months of the making of the provisional order.
- 3.27 Once the Authority is satisfied that a licence holder has contravened a relevant condition or requirement, or failed to achieve a relevant standard of performance, and the Authority has decided that a penalty is appropriate and what amount it should be, the Authority will give notice, as required by sections 59 and 95. The notice will:
- ◆ state that the Authority proposes to impose a penalty and the amount of the penalty proposed to be imposed;
 - ◆ set out the relevant condition or requirement or standard of performance in question;
 - ◆ specify the acts or omissions which, in the opinion of the Authority, constitute the contravention or failure in question and the other facts which justify the imposition of a penalty and the amount of the penalty proposed; and

- ◆ specify the period (not less than 21 days from the date of publication of the notice) within which representation or objections with respect to the proposed penalty may be made.
- 3.28 The Authority shall consider any representations or objections made, vary the proposal if appropriate, give notice of any such variation and consider representations or objections, before giving notice of the imposition and amount of any penalty and the date by which payment must be made.

Decisions on the Appropriateness of a Penalty

- 3.29 Before any consideration of whether it would be appropriate “in all the circumstances of the case” to impose a financial penalty on the licensee, the Authority must first determine that it is permitted to impose such a penalty. The Authority is precluded from imposing a financial penalty under sections 59 and 95, if it is satisfied that the most appropriate way of proceeding is under the Competition Act 1998. If the Authority reaches no such conclusion, then the Authority may continue. **In deciding whether it is appropriate to impose a financial penalty for any contravention or failure, the Authority will consider the effect of that contravention or failure in relation to its principal objective and general duties (contained in the Electricity Act and the Gas Act).** The Authority’s principal objective and general duties are laid out in paragraphs 3.1 to 3.6.
- 3.30 Ofgem is of the view that penalties should be used to incentivise compliance. It should therefore be more expensive for a licensee to continue in breach of a licence condition, relevant requirement or standard of performance than it is to comply with the licence condition, relevant requirement or standard in question. The imposition of a penalty should also deter other licensees from engaging in similar practices.
- 3.31 Ofgem’s principal objective is to protect the interests of consumers, wherever appropriate by promoting effective competition. Ofgem therefore considers it appropriate to impose a penalty where a contravention or failure damages the interests of consumers and/or market participants or which results in a financial or other gain by the licensee in breach. The damage or harm caused could be an increase in costs to all consumers and/or other market participants, for

example market manipulation which causes prices to rise. Or the damage could lead to inconvenience or extra work for a particular group of consumers and/or other market participants, for example a failure by a distribution business to keep appointments with customers when acting on behalf of suppliers.

- 3.32 It has been argued that financial penalties should only be imposed where there has been a deliberate contravention or failure and where remedial action has not been taken. Intent and the extent of any remedial action taken will, of course, need to be considered in determining the appropriateness of imposing a financial penalty. However, it is Ofgem's view that the appropriateness of imposing a financial penalty on the licensee should be considered in all cases where the interests of consumers and/or competitors have been affected, or could have been affected, whether by design, negligence or accident. Ofgem considers that discussions between the Authority and the licensees during such considerations would assist the Authority in determining whether the imposition of a financial penalty would be appropriate.
- 3.33 Ofgem's initial view is that a one-off contravention or failure which affects a single small customer or very small number of consumers (for example, one isolated instance of mis-selling or one failure of the standard of performance to keep an appointment) would not be likely to attract a penalty, although the failure to meet a standard could of course give rise to a compensation payment. However, a simple contravention which affected larger numbers of consumers or which had, or could have had, a seriously detrimental effect on competition or competitors, or repeated failures with less significant effects would be likely to attract a penalty (in addition to any compensation payment due). For example, widespread or persistent mis-selling would incur a penalty, as would widespread or persistent failure to meet the standard of performance in relation to keeping appointments. Another example might be failure by a distributor to provide the required metering services in its distribution service area. This would be a contravention of a licence obligation which could adversely impact suppliers wishing to use these services and could act as a barrier to new entrants and therefore have a detrimental effect on competition.

Procedure

- 3.34 The Electricity Act and the Gas Act, as amended by the Utilities Act, will set out certain steps that the Authority must follow when seeking to impose financial penalties for breaches of relevant conditions or requirements. These steps are described in paragraphs 3.27 and 3.28 above.
- 3.35 As a result of the requirement on the Authority to take these steps, companies against whom enforcement action is contemplated will be informed promptly of the nature of the complaint against them and will have adequate time and opportunity to make representations.
- 3.36 The Electricity Act and the Gas Act confer on the Authority, during the early stages of the enforcement processes laid out in sections 25 and 28 respectively, functions that involve ascertaining the factual background, identifying breaches of licence and other requirements and forming a view on whether breaches have occurred. In order properly to perform these functions, Ofgem has found it helpful in the past, informally, to introduce additional procedural steps into the enforcement process. These are, in cases where it is not felt that a provisional order is required:
- (a) to offer oral hearings to allow the companies concerned to review the facts on which Ofgem is relying and to make representations; and
 - (b) to advise companies against whom enforcement action is being taken of the decisions Ofgem is minded to take, and to allow further representations before a final decision is taken.
- 3.37 **Ofgem proposes, subject to responses to this consultation, generally to offer such oral hearings to licence holders against whom the imposition of financial penalties is being considered. Ofgem also intends to advise those companies of its anticipated penalty decisions on a “minded to” basis before publishing a notice of its proposed imposition of a financial penalty.**
- 3.38 **Views are sought on the appropriateness of these proposals.**

4. Calculation of Penalties

- 4.1 The Utilities Act limits the amount of any financial penalty. The penalty must be “of such amount as is reasonable in all the circumstances of the case” and must be no more than 10% of the turnover of the licensee. The licensee’s turnover will be determined, for these purposes, in accordance with provisions specified in an order made by the Secretary of State (and approved by a positive resolution of each House of Parliament).
- 4.2 In calculating the level of any financial penalty to be imposed under the Competition Act 1998, the DGFT begins by applying a percentage rate (up to a maximum of 10%) to the undertakings “relevant turnover”. The DGFT’s approach to the calculation of Competition Act financial penalties is outlined in the Office of Fair Trading’s guidance: OFT 423 (see paragraph 2.18). However, given the wide range of contraventions or failures for which Utilities Act penalties could be imposed, and given that such contraventions or failures might have very different effects on consumers and/or the energy market, it is not considered that a similar approach should be adopted in relation to Utilities Act financial penalties.
- 4.3 Ofgem considers that the starting point for determining any actual or potential financial penalty, should be the seriousness of the contravention or failure, the harm or increased cost to consumers and/or market participants and any gain (financial or otherwise) made by the licensee as a result.
- 4.4 The actual penalty applied will therefore depend on the nature of the contravention or failure. As previously indicated, Ofgem’s objective in setting monetary penalties is to incentivise compliance with the relevant condition, requirement or standard without introducing unnecessary risks to licensees. The potential penalty would therefore be proportionate to the nature and seriousness of the breach. The more serious the impact, or potential impact, of the contravention or failure on consumers or on the competitive market and the greater the profit/gain of the licensee, the higher the penalty is likely to be. For example a manipulation of the market which had wide ranging detrimental effects on consumers and other market participants by increasing prices to all consumers, would incur a high penalty. Ofgem proposes that the amount of any penalty may be increased or decreased to take into account the duration and

frequency of any contraventions or failures. An infringement of short duration which was swiftly rectified would see a lower penalty than a lengthy infringement. In the above example, the penalty would therefore be based on the increase in price and the length of time over which the price increase was sustained, subject to the 10% cap.

4.5 Ofgem proposes that the penalty figure reached after taking account of the seriousness of any impact on consumers and/or the competitive market and the duration of any contravention or failure should be capable of adjustment for a number of other factors.

4.6 These include increases where:

- ◆ there is a need to deter others from engaging in the same practices;
- ◆ there are aggravating factors such as:
 - repeated contraventions or failures;
 - continuation of the contravention or failure after the start of the investigation;
 - involvement of directors or senior management;
 - contraventions or failures which are deliberate or reckless or where appropriate procedures or safeguards have not been introduced; and
 - the extent to which the licensee actively concealed the contravention or failure from the Authority.

4.7 Decreases in the size of the penalty might be appropriate where there are mitigating factors such as:

- ◆ genuine uncertainty, on the part of the licensee, as to whether the conduct involved constituted a contravention or failure;
- ◆ the extent to which steps had been taken to promote compliance and any active compliance plan in place;

- ◆ the extent to which the licensee had taken steps to remedy a contravention or failure;
- ◆ accidental contravention or failure rather than intentional; and
- ◆ co-operation with the Authority which enables the investigation and any action to be concluded more effectively and/or speedily than would otherwise be the case.

4.8 Ofgem also proposes that a decrease in the penalty would be considered to take account of any fine or compensation payment made (whether required by law or made voluntarily) in respect of the same contravention or failure and the likelihood that the licensee will face a civil action from persons affected by the contravention or failure.

4.9 An Information and Incentives Project (IIP) is currently being undertaken by Ofgem. As part of that project Ofgem is in the process of reviewing the incentives placed on electricity distribution businesses to deliver an appropriate quality of supply. It is Ofgem's expectation that as a result of this project, output based incentive regimes will be introduced from April 2002, covering for example the number and duration of interruptions to supply. Ofgem has explained in previous consultation papers on the IIP that it will be important to consider the relationship between any payments made in respect of the incentive regimes and any financial penalty imposed under the Utilities Act. Therefore, Ofgem proposes that a decrease in the penalty would be considered to take account of any incentive payment made by the distribution business arising from its performance under the incentives regime.

4.10 Where a number of licensees are acting together (or have in the past acted together) in contravention of any relevant condition or requirement, Ofgem proposes to encourage licensees to come forward with evidence of such action. Ofgem believes that it is in the interest of both consumers and other market participants to take all possible steps to ensure that licensees do not act together in this manner. Ofgem therefore proposes that leniency may be afforded to licensees who inform the Authority of such activities and then co-operate with the Authority's investigation. It is Ofgem's view that the interests of consumers

and market participants are better served by bringing such contraventions to an end than in obtaining a financial penalty from a particular licensee.

- 4.11 As noted previously, the Authority has, in carrying out its functions, to have regard to the need to secure that licence holders are able to finance their activities. As a final step in the process, the Authority would expect to check that the potential penalty derived from consideration of the issues described above would not conflict with this requirement. However, Ofgem does not consider that these financing duties require it to protect companies from their own inefficiency. It is Ofgem's present view that it would be inappropriate to refrain from imposing a financial penalty which is sufficient to incentivise compliance merely because this would make it difficult for a highly inefficient licensee to finance its functions.
- 4.12 The size of any financial penalty will therefore be based on harm and/or cost to consumers and market participants of any contravention or failure, any gain (financial or otherwise) made by the party in breach and the duration of the breach. Having decided on the initial size of the penalty, it will then be increased or decreased to reflect any aggravating or mitigating circumstances that apply and to ensure that it acts as a deterrent to others.
- 4.13 Ofgem will then need to consider the licensee's ability to continue to finance its activities in the light of the penalty proposed (as required under the Authority's objectives and duties, laid out in paragraphs 3.1 to 3.6). It may be appropriate for the penalty to be paid in instalments. Finally, Ofgem will check that the level of the penalty does not exceed 10% of the licensee's turnover. In addition to these considerations, Ofgem will need to remain mindful that it is precluded from imposing a financial penalty under sections 59 and 95 if it is satisfied that the most appropriate way of proceeding is under the Competition Act 1998.
- 4.14 **Views are invited on whether there are other factors beyond those described in this chapter which should influence the level of any penalty.**

5. Conclusion and Next Steps

5.1 Views are invited on the issues raised in this paper in respect of the imposition of Utilities Act financial penalties and the calculation of their amount. In particular views are sought on:

- ◆ **whether hearings should be offered to licence holders against whom the imposition of financial penalties is being considered (paragraph 3.37);**
- ◆ **whether licence holders against whom the imposition of a financial penalty is being considered should be advised of any anticipated penalty decisions on a “minded to” basis before notice of the proposed imposition of a financial penalty is published (paragraph 3.37); and**
- ◆ **whether there are other factors beyond those described in chapter 4 which should influence the level of any penalty (paragraph 4.14).**

5.2 Views are invited by **Friday 29 September 2000** and should be sent to:

Pam Barrett
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Fax: 020-7932-5197

Email: pam.barrett@ofgem.gov.uk

5.3 Responses will be published by placing them in the Ofgem library unless they are clearly marked “Confidential – Not for Publication”.

5.4 In the light of the views of respondents, Ofgem will publish a statement of policy with respect to the imposition of penalties and the determination of their amount prior to the relevant clauses taking effect. The Act permits the Authority to revise its statement of policy, and where it does so, to publish a revised statement. Any proposed revisions to the statement of policy will be consulted on.

ANNEX A

Sections of the Electricity Act 1989 which are “relevant requirements” under section 25(8) of the Electricity Act (as amended by the Utilities Bill)

Section 9 - General duties of licence holders;

Section 16 – Duty to connect on request;

Section 16A – Procedural requirements;

Section 17 – Exceptions from duty to connect;

Section 19 – Power to recover expenditure;

Section 20 – Power to require security;

Section 21 – Additional terms of connection;

Section 22 – Special agreements with respect to connection;

Section 23 – Determination of disputes;

Section 32 – Obligation in connection with electricity from renewable sources;

Section 32A – Orders under section 32: supplementary;

Section 32B – Green certificates;

Section 32C – Payment as alternative to complying with order under section 32;

Section 40 – Overall standards of performance: electricity suppliers;

Section 40A – Overall standards of performance: electricity distributors;

Section 42 – Information to be given to the Authority on standards of performance;

Section 42A – Information to be given to customers about overall performance;

Section 42C – Remuneration and service standards;

Section 43A – Adjustment of charges to help disadvantaged groups of customers;

Section 43B – Statutory Instrument (to make an order under 43A); and

Section 27(4)(b) of the Utilities Act 2000 – Order to secure compliance with a direction made under section 24 of that Act

ANNEX B

Sections of the Gas Act 1986 which are “relevant requirements” under section 28(8) of the Gas Act (as amended by the Utilities Bill)

Section 9(1), (1A) or (2) - General Powers and duties;

Section 10(2), (3) or (14) – Duty to connect certain premises;

Section 10A(1) - Restriction on use of certain pipe-lines for providing a supply;

Section 11(2) – Power to require security;

Section 12(1) or (6) – Methods of calculating therms;

Section 16(10) – Standards of gas quality;

Section 18(11) – Safety Regulations;

Section 22A(1) – Construction of pipe-lines;

Section 27A(5) or (6) – Determination of certain disputes;

Section 33B – Overall standards of performance: gas suppliers;

Section 33BA – Overall standards of performance: gas transporters;

Section 33C – Information with respect to levels of performance;

Section 33D – Information to be given to customers about overall performance;

Section 33F – Service standards and remuneration;

Section 41A – Adjustment of charges to help disadvantaged groups of customers;

Section 41B – Statutory instrument (making an order under 41A);

Schedule 2B – The Gas Code:

para 3 - Meters to be kept in proper order;

para 6 – Meters for disabled persons;

para 15 - Maintenance etc. of service pipes;

para 16 – Alterations etc. of burners on change of calorific value;

para 20(5) – Notified escapes of gas;

para 28(1) – Provisions as to powers of entry; and

Section 27(4)(b) of the Utilities Act 2000 – Order to comply with a direction under section 24.

