

**Making markets work for consumers:
Ofgem's approach to securing compliance
with supply licence obligations and
consumer protection legislation**

A consultation document

July 2003

Summary

Ofgem's supply compliance strategy aims to support competitive supply markets in which consumers are empowered to engage and are not constrained by a lack of confidence that suppliers will provide an adequate level of service. The strategy recognises the need to balance a desire for minimum levels of service with the aspects of quality that may be the dimensions of competitive differentiation.

The strategy has three drivers:

- confident and empowered consumers are essential to the operation of a mature market;
- consumer confidence is underpinned by supplier compliance with legal and licence obligations; and
- suppliers can be incentivised to comply through the positive encouragement of compliance cultures and by credible enforcement arrangements.

The principles of Ofgem's supply compliance strategy are proportionality, accountability, consistency, targetting and transparency.

The Gas and Electricity Markets Authority is required to exercise its discretion in performing its duties or exercising its powers. The priorities that have guided Ofgem's supply compliance activity are put into the public domain for the first time:

- securing compliance with obligations or arrangements which provide for security of supply and the safety of consumers;
- securing compliance with obligations or arrangements which facilitate the engagement of consumers within the market; and
- securing compliance with obligations that protect individuals who are disabled or chronically sick; individuals of pensionable age; individuals with low incomes; and individuals residing in rural areas.

Views on these priorities are being invited. The paper also invites views on a proposal to publicise the fact that Ofgem has begun a formal investigation. The closing date for responses is Friday 12 September 2003.

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1. Summary impact assessment

- 1.1. This paper describes Ofgem's approach to securing compliance with customer facing licence and legal obligations and does not describe Ofgem's approach to monopoly network or wholesale market regulation. It is primarily concerned with the way in which retail suppliers interact with consumers, and is focused on securing consumer confidence and therefore engagement within the market, through the enforcement of minimum standards.
- 1.2. Changes to individual regulatory obligations would be the subject of impact assessment. However the statutory obligations upon the Authority, and the statutory and licence obligations upon suppliers, make an impact assessment of a document on compliance strategy and process inappropriate.

2. Background

- 2.1. Developments within supply markets suggest that it is appropriate to set out clearly Ofgem's position with respect to the monitoring and enforcement of compliance with licence conditions and consumer protection legislation
- 2.2. Competition within gas and electricity markets continues to develop. The supply market is characterised by large numbers of consumers who have switched, or who intend to switch, with all consumers benefiting from competition through lower prices and increasingly innovative service offerings. Ofgem removed regulatory control from domestic retail prices from April 2002, in response to concerns that continued price controls would not be in consumers' best interests. However at that time Ofgem made it clear that it was not countenancing a policy of inactivity, but that with regard to retail markets its duties to consumers could be fulfilled best by *ex post* enforcement.
- 2.3. Ofgem protects consumers through enforcement of the Competition Act 1998, the sectoral rules laid down in supply licences, and a range of general consumer protection regulations. This document sets out Ofgem's approach to enforcement of the licences and these regulations. It does not relate to our approach to enforcement of the Competition Act, which has been described in the energy guidelines: 'Competition Act 1998 – the application in the energy sector', OFT 428, March 2001'.
- 2.4. In April 2002 secondary legislation was enacted that gave effect to the provisions of the Utilities Act 2000 under which the Authority received powers to impose financial penalties on a licence holder which has contravened any relevant licence condition or requirement. Since that date the Authority has exercised its power on two occasions. In November 2002 the Authority imposed a penalty of £2 million on London Electricity plc for mis-selling to gas and electricity customers. In June 2003 the Authority imposed two penalties totalling £200,000 on British Gas Trading plc for inappropriately objecting to the transfer of some direct debit customers. Both cases received widespread media coverage and have given a clear indication that the Authority is ready to use its powers.

2.5. This paper seeks to describe the framework for Ofgem's compliance activity, in order to provide a measure of certainty for suppliers and underpin consumer confidence within the market. It will cover the following issues:

- the legal background;
- strategic objectives;
- the nature and scope of compliance monitoring and enforcement;
- priorities for action within legal and resource constraints;
- the principles of Ofgem's compliance strategy; and
- the processes which will be employed.

2.6 It is outside the scope of this paper to assess the relevance and appropriateness of existing supply licence conditions. These are reviewed from time to time, either as Ofgem policy develops or as suppliers suggest that review is necessary. For example, standard licence condition 48, which regulates suppliers' direct selling, will be reviewed in a forthcoming Ofgem consultation document.

3. Legal framework

- 3.1 Under the Gas Act 1986, the Gas and Electricity Markets Authority has a principal objective to protect the interests of consumers in relation to gas conveyed through pipes, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas so conveyed.

Under the Electricity Act 1989, the Gas and Electricity Markets Authority has a principal objective to protect the interests of consumers in relation to electricity conveyed by distribution systems, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity.

- 3.2 The Authority grants licences for the supply of gas and electricity.
- 3.3 Under section 28 of the 1986 Act and 25 of the 1989 Act, where it is satisfied that a licence holder is contravening or is likely to contravene any relevant condition or requirement, the Authority shall make such provision as is requisite to secure compliance with the condition or requirement. Such provision will take the form of a provisional or final order. The Authority cannot make an order if it is satisfied that the most appropriate way of proceeding is under the Competition Act 1998.
- 3.4 Sections 30A of the 1986 Act and 27A of the 1989 Act provide that, where it is satisfied that that a licence holder has contravened any relevant condition or requirement or has failed or is failing to achieve any standard of performance, the Authority has the power to impose a financial penalty of such an amount as is reasonable in all of the circumstances of the case. The Authority cannot impose a penalty where it is satisfied that the most appropriate way of proceeding is under the Competition Act 1998.
- 3.5 The policy and process which will be followed by the Authority has been published in two documents:
- April 2001, Utilities Act Statement of policy with respect to financial penalties; and

- February 2003, Financial penalties, the process.
- 3.6 Where it appears to the Authority that a licence holder may be contravening or may have contravened a relevant licence condition or requirement, the Authority has the power, under sections 30 of the 1986 Act and section 28 of the 1989 Act, for the purposes of its functions, to require the provision of information or documents from any person. Standard licence condition 19 of both gas and electricity supply licences requires licence holders to provide such information, or reports, as are reasonably required by the Authority for the performance of its functions.
- 3.7 The Authority is required to exercise its discretion in performing its duties or exercising its powers. For example it must determine whether a contravention is 'trivial'. In addition if the Authority is satisfied that a contravention has occurred it must take action. But where a breach is not clear without further investigation, the Authority must decide whether or not to devote resources to finding out. When considering its enforcement options the Authority will be guided by its principal objective and the statutory terms of the particular enforcement actions.
- 3.8 In addition to its duties and powers with regard to licence compliance the Authority also has concurrent powers with the Office of Fair Trading for the enforcement of a range of Regulations including:
- The Unfair Terms in Consumer Contracts Regulations 1999;
 - The Consumer Protection (Cancellation of Contracts Concluded Away From Business Premises) Regulations 1987; and
 - The Consumer Protection (Distance Selling) Regulations 2000.
- 3.9 Under the Enterprise Act 2002, the Authority has been designated an 'enforcer' and has the power to obtain an enforcement order in relation to breaches of consumer protection legislation. Legislation covered by the Act includes:
- The Control of Misleading Advertisements Regulations 1998 (as amended);
 - The Consumer Protection (Cancellation of Contracts Concluded Away From Business Premises) Regulations 1987;

- The Unfair Terms in Consumer Contracts Regulations 1999; and
- The Consumer Protection (Distance Selling) Regulations 2000.

4. Supply compliance strategy

Objectives of compliance

- 4.1 The discussion below takes for granted that Ofgem will comply with its legal obligations where these require it to take enforcement action. However, as noted above, the legal regime leaves Ofgem some discretion and this section discusses how this discretion may be used.
- 4.2 The objective of Ofgem's supply compliance strategy is identical to Ofgem's overall principal objective: to protect the interests of gas and electricity consumers, wherever appropriate by promoting effective competition. Specifically we aim to support a competitive supply market in which customers are empowered to engage with the competitive market (for example by being provided with appropriate information) and are not constrained from participation by a lack of confidence that suppliers other than their current one will provide a defined minimum level of service. Ofgem's compliance priorities, which are described in section 5, are to provide for consumer safety, to facilitate consumer engagement with the competitive market and protection of disadvantaged consumers.
- 4.3 Ofgem recognises that there is a trade-off between the benefit to consumers of establishing standards of performance which are common to all suppliers, and allowing suppliers the opportunity to differentiate their brands in terms of quality of service as well as price. The former approach can provide customers with certainty and confidence, but is limited in that it assumes that all consumers will value standards of performance to the same extent. This is unlikely to be the case, and if consumers determine combinations of price and service quality through their purchasing decisions, the outcome will be more reflective of consumer preferences. Allowing for different levels of service quality can also support entry into the market, as it will make lower price/service propositions viable, and further extend consumer choice. As a general matter, therefore, Ofgem aims not to regulate the aspects of quality that are or are likely to become dimensions of competitive differentiation.

- 4.4 However, this general policy applies only where it can be credibly asserted that consumers have or are likely to gather information about the service standards in question. Where there is a lack of information, and where consumers do not have a generalised confidence that a uniform minimum of service prevails in the market, consumers may fear that any assessable switching benefits will be outweighed by poorer service from a new supplier. Such fears will be likely to make consumers more conservative and to switch less, and so potentially to miss opportunities to capture a price-service-brand package that would better fit with their preferences.
- 4.5 At present it does not appear that consumers are well-informed as to different suppliers' service standards. While there is some information on the energywatch website, there is no source of comprehensive information that is widely available to consumers,. Moreover, there is a continual level of media reporting that would tend to increase consumers' level of anxiety about prevailing standards of service from energy suppliers.
- 4.6 In Ofgem's view it therefore remains important, in today's market conditions, to ensure that a uniform minimum of service applies in some areas. This imperative is to be balanced with the overall desirability of not distorting competition through over-regulation. The conditions of the supply licence contain a set of obligations that embody this balance and Ofgem will also take account of the same need for balance in its enforcement of general consumer protection legislation.
- 4.7 One category of regulatory obligation has a role that cuts across the policy issues discussed in the previous paragraphs. These are obligations whose objective is to ensure that consumers are empowered to engage with the competitive market. (Examples would be the obligation to inform consumers regularly of their meter number and of their consumption, key pieces of data if the consumer wishes to switch.) Ofgem will place great store on securing compliance with these obligations. (We also recognise that the line between these "consumer empowerment" conditions and the generality of supply licence obligations is not always clear-cut.)
- 4.8 Ofgem's compliance strategy therefore currently has three drivers:

- confident and empowered consumers are essential to the operation of a mature competitive market. Through exercising choice freely consumers will ensure that the benefits of competition are realised;
- consumer confidence is underpinned by supplier compliance with legal and licence obligations; and
- suppliers can be incentivised to comply with their licence obligations, the incentive to comply can be provided by the positive encouragement of 'compliant cultures' and by credible enforcement arrangements.

Consumer confidence

4.9 Gas and electricity supply is a utility service and is of vital importance to the health and wellbeing of consumers, particularly vulnerable consumers. Consumer confidence is influenced by the personal experience of consumers, their families and friends and is underpinned by the expectation that arrangements exist for the provision of consumer protection measures.

4.10 Confidence is also influenced by media coverage. The gas and electricity supply markets have experienced extensive media interest since competition was introduced. Recently this has focused on two key areas, the first resulting from specific campaigns to raise consumer awareness about the existence of competition and the benefits to be achieved from switching supplier. Research has shown that this has been effective, as in 2002 92% of consumers were aware that they could purchase their gas and electricity from other suppliers¹. The second area of interest has been instances where the market has failed to deliver benefits, in particular through the misselling of gas and electricity supply contracts, but also the failure of suppliers to bill promptly or accurately and to handle complaints effectively. Although research suggests that consumers are not so far deterred from participating in the market, it is of concern that the impact on the reputation of the market could increasingly influence consumer behaviour.

4.11 Compliance activity with a high public profile can potentially have two effects; it may reassure consumers that an effective and active enforcement agency is

working on their behalf and so build confidence in market arrangements. Alternatively, by drawing attention to problems in the market, it could undermine confidence unnecessarily. Ofgem believes that, in today's conditions, poor service by suppliers will attract media attention, whether or not Ofgem acts against it. Ofgem therefore considers that, at present, visible enforcement activity reinforces consumer confidence, not the contrary.

Incentives to comply

- 4.12 Ofgem recognises that most companies aim to comply with their licence and legal obligations. However, suppliers have to make decisions about resource allocation, and these extend to what steps they take to secure compliance with their licence and other legal obligations. Even if a supplier's senior management desires to secure compliance, it is wholly possible that an under-allocation of resources (or allocating them badly) can result in non-compliance. Such a mismatch between corporate aspiration and actual results may arise from a lack of alignment between the views of senior management and lower-level staff, or from a lack of information passing from the "front line" to senior decision-makers.
- 4.13 Ofgem also recognises that some companies may make decisions by weighing up the costs of compliance against the perceived benefits of non-compliance (which will be a factor of the probability of being discovered and punished, and the severity of the penalty. In this context the 'punishment' may be a formal sanction from a regulatory body and/or unwanted publicity about the non-compliance.)
- 4.14 Whichever of these views is adopted, it would appear companies are more likely to comply in practice if an effective "feedback loop" is created. This will extend both to ensuring that information about compliance or non-compliance becomes available to suppliers' senior staff, and to ensuring the correct incentives are in place to promote compliance. Ofgem therefore views its role as securing compliance:
- by encouraging compliance cultures within supplier businesses; and

¹ JD Power, Domestic Gas and Electricity Consumer Studies 2002

- by taking proportionate, consistent and transparent enforcement action, when it becomes aware of non-compliance.

Encouraging consumer protection cultures

4.15 Ofgem will encourage compliance among supplier businesses through its support, both in private and in public, for initiatives which will lead to compliance. It will continue to work with suppliers to develop solutions to recognised industry problems such as the transfer process and will support appropriate self-regulatory initiatives such as the recently launched code of practice on doorstep selling.

4.16 Ofgem sees particular benefits in self-regulatory or co-regulatory approaches, as these may help to ensure that suppliers capture business benefits whilst still ensuring a uniform minimum of customer service. Indeed, to the extent that the uniform minimum can be defined flexibly, in the light of suppliers' approach to the market, this approach can reduce to a minimum the competitive distortion such regulation may introduce.

4.17 Ofgem expects to see compliance acknowledged and addressed at the highest levels within supplier businesses. Ofgem regards a culture of compliance as likely to include some or all of the following characteristics:

- senior management responsibility for compliance;
- compliance identified within both business and individual objectives, alongside quality and other performance measures;
- awareness among operational staff of regulatory requirements, supported by internal communications and training;
- documented processes reflecting licence obligations;
- firmly established compliance monitoring, audit and reporting; and
- consideration of compliance requirements in formal project planning and decision making mechanisms.

This list is not intended to be either prescriptive or exhaustive.

Principles of Ofgem's compliance programme

4.18 Ofgem's compliance activity is undertaken with the following principles in mind: that it should be proportionate, consistent, accountable, targetted and transparent.

4.19 The notion of proportionality is provided for within the legal framework which imposes duties upon Ofgem.

This framework provides for flexibility of approach in the following ways:

- through a threshold of triviality , that is, the Authority is not required to make an order or impose a financial penalty if it is satisfied that the matter is trivial;
- through a threshold of satisfaction, that is before making an order or imposing a penalty, the Authority must satisfy itself as to the contravention of relevant conditions or requirements; and
- in determining when and how to use our 'powers', rather than duties.

In this way a proportionate response will reflect the impact on consumers, regulated companies and the effective working of the competitive market. Remedies will be appropriate to the risk posed, and costs will be minimised.

4.20 Ofgem recognises that it must be consistent in its treatment of both licence holders and consumers, but takes into account its particular duties with regard to the interests of vulnerable consumers. The interests of all consumers, supply companies and their shareholders are likely to be served by an enforcement regime which is predictable and consistent.

4.21 Transparency has been recognised as a key principle for effective regulation.

Ofgem has sought to achieve transparency in its compliance activity, in particular through the publication of its policy and processes for the imposition of financial penalties. However to date compliance investigations have been conducted in private, until the Authority has exercised its power to consult on the proposal of a financial penalty. Licence holders have expressed the view that to publicise an investigation before any finding of breach would have an adverse impact on their businesses, which may prove to be unwarranted. However, this view must be balanced by the fact that investigations into allegation of breach may be both

complex and time consuming and that during that time it can appear to the public that no action is being taken. The publication of an investigation can lead to the reporting of further information which will support the investigation. Ofgem has therefore concluded that the consumer interest would be served by publicising that an investigation is taking place. Further details of this proposal are included at paragraph 6.6.

5. Supply compliance priorities

- 5.1 Ofgem priorities for 2004-6 are expressed in the Ofgem Corporate Strategy 2003-2006².
- 5.2 Within this corporate strategy framework, and within the compliance strategy outlined above, Ofgem's current priorities for its supply compliance activity are to make markets work for consumers by:
- securing compliance with obligations or arrangements which provide for security of supply and the safety of consumers;
 - securing compliance with obligations or arrangements which facilitate the engagement of consumers with the market; and
 - securing compliance with obligations that protect individuals who are disabled or chronically sick; individuals of pensionable age; individuals with low incomes; and individuals residing in rural areas.
- 5.3 In 2003/4 Ofgem has made a small increase in the resources available for supply compliance monitoring and enforcement, reflecting the importance of this work for customers; however, it will still be required to prioritise the allocation of these resources. It will do so in line with the priorities identified above. Ofgem will allocate resources and target compliance activity to address these specific priorities, but will not be constrained from taking any other action necessary to perform its statutory duties or in the exercise of its statutory powers.
- 5.4 **Ofgem would welcome views on the priorities for action expressed in this section.**

² Ofgem Corporate Strategy 2003-2006 March 2003

6. Monitoring and enforcement in practice

6.1 In monitoring supply compliance, Ofgem gathers statistical and qualitative information from both external and internal sources, including the following:

- energywatch;
- licenced suppliers, their employees, former employees and contracted agents;
- Citizens Advice;
- members of the public;
- the Office of Fair Trading;
- the Department of Trade and Industry;
- Members of Parliament;
- the Police;
- trading standards departments; and
- the media.

From this information, and in accordance with its priorities, Ofgem will determine what action it will take.

6.2 In deciding whether to take action against a specific supplier Ofgem will have regard to the comparable performance of other suppliers, where this information is available. However, there may be cases where Ofgem regards it as in consumers' interests for it to take enforcement action against suppliers who may not be in a worse compliance position than others, for example where this is important to sustain consumer confidence. The decision on whether subsequently to take action against other suppliers will be made on a case by case basis and in accordance with Ofgem's priorities. If Ofgem becomes aware of non compliance

then it is required to act. Its statutory duty does not specify that it should only do so in the most serious cases.

- 6.3 It may be that general non-compliance with a licence condition is the result of particular arrangements or circumstances within the industry which suggest that that the licence condition should be reviewed. If that is the case, then a review will be a matter for the relevant Ofgem policy team. However, it is not the case that non-compliance by other suppliers will, of itself, be sufficient grounds for Ofgem not to take action.
- 6.4 There will be circumstances in which legal or licence obligations require that a company takes 'all reasonable steps' (or an equivalent). Ofgem will not, as a matter of course, provide information which defines the meaning of such terms, and interpretation may differ according the circumstances. However, in determining whether a supplier has done all that is reasonably required, Ofgem will tend to give more weight to the consumer interest, rather than the supplier interest and may, if appropriate, issue guidance.
- 6.5 The options for action will include:
- informal discussion with a supplier to establish the nature and scope of the alleged non-compliance, with a view to securing compliance; or
 - a formal investigation which may lead to the imposition of a sanction by the Authority.

The choice between these two approaches will be based on the following characteristics of the alleged non-compliance:

- the level of evidence
- the seriousness of the alleged non-compliance, in particular in terms of its impact upon consumers, the market in general or other suppliers;
- attempts by the supplier to draw the matter to Ofgem's attention;
- redress provided to those affected by the non-compliance; and
- whether non-compliance is ongoing.

Ofgem may decide at any time that informal discussions should become a formal investigation. We will make this clear to the supplier and will give formal notice in advance of publicising the fact of an investigation (see 6.6). Ofgem will not be constrained by its earlier informal discussions and suppliers should be aware that any information provided in the course of informal discussion could become relevant to a formal investigation.

Informal action

- 6.6 Informal discussion with a supplier will provide an opportunity to assess an allegation of non-compliance and may result in an agreement to comply with the relevant licence obligations or legislation, and where appropriate offer redress to consumers who have been affected; or a decision to move to a formal investigation. Informal action will not usually be made public, although the outcome may be, depending on the circumstances. Informal action will sometimes be the most appropriate course of action, particularly if prompt action is required, and can produce the best outcome for consumers.

Formal investigation

- 6.7 Before commencing a formal investigation Ofgem will write to a supplier informing them that they will be the subject of a formal investigation.
- 6.8 Formal supply investigations will be carried out in accordance with Ofgem's internal supply compliance manual.
- 6.9 When the investigating team has completed its investigation, it will report either that it finds no instance of non-compliance or that the case should be considered for a possible sanction.
- 6.10 If it is recommended that the matter be considered for a possible sanction and that sanction could be a financial penalty, the investigating team will prepare a report of the facts which will be shared with the company, in order to correct any inaccuracies. The report will form the basis of a report to the Authority.
- 6.11 The subsequent procedure followed by the Authority is outlined in its document, 'Financial penalties, the process', February 2003.

Publication

6.12 In the interests of transparency Ofgem proposes to provide, on its website, a summary of the formal investigations into breach of licence conditions that it is undertaking. This information would not be limited to supply investigations, would be available freely and would include a summary of the allegations or complaints that are the basis of the investigations. However it would not include publication of an investigation:

- of general market phenomena;
- if to do so might prejudice that or a related investigation;
- if to do so could have an impact on security of supply; or
- it in any way conflicted with the Authority's statutory duties.

The identity of a complainant would not be publicised unless the complainant had requested such publicity or, in exceptional cases, where it was in the interests of consumers more widely. Where possible the information would include an indication of the progress of the investigation. However, it should be noted that a formal investigation can take many months to complete. Ofgem would not provide any further comments on cases under investigation beyond the information published. Competition Act investigations would also be included.

6.13 Ofgem seeks views on the proposal to publicise its decision to undertake a formal investigation.

6.14 At least annually, Ofgem will publish a bulletin providing details of the formal enforcement action it has taken; this will include the outcome of Competition Act investigations.

Coordination with other enforcement authorities

6.14 Ofgem co-ordinates its enforcement of non-licence matters with other regulatory bodies, in particular the OFT. A formal concordat outlining the arrangements

between the two bodies is being discussed. Ofgem contributes to the Consumer Regulation Website.

7. Further information

7.6 If you would like to discuss any issues arising from the publication of this paper, or comment on the two areas for which views have been requested, then please contact:

Annette Lovell

Head of Customer Contact and Compliance

Ofgem

9 Millbank

London

SW1P 3GE

Telephone: 020 7901 7443

Email: annette.lovell@ofgem.gov.uk

7.2 All responses will normally be published on the Ofgem website and held electronically in the Ofgem Research and Information Centre unless there are good reasons why they must remain confidential. Where possible any confidential material should be placed in appendices to responses. Ofgem prefers to receive responses in an electronic form so they can easily be placed on the Ofgem website. The closing date for responses is Friday, 12 September 2003.