

Notice under section 27A of the Electricity Act 1989

Proposal of the Gas and Electricity Markets Authority to impose a financial penalty, following an investigation into compliance with SLC 4D, SLC 12 and SLC 30 of the electricity distribution licence by Central Networks East plc and Central Networks West plc

7 February 2011

1. Summary

- 1.1. The Gas and Electricity Markets Authority ("the Authority") proposes to impose a financial penalty on Central Networks East plc and Central Networks West plc (collectively referred to as "CN") and considers that CN has breached its licence obligations under its electricity distribution licence, specifically standard licence condition 4D ("SLC 4D"), standard licence condition 12 ("SLC 12") and standard licence condition 30 ("SLC 30").
- 1.2. The obligation on licensees in SLC 4D and SLC 12 is to provide offers for connection as soon as practicable/reasonably practicable and in any event within three months of receipt of an application which contains all such information as the licensee may reasonably require for the purposes of formulating the offer¹. SLC 30 requires a licensee to have available to itself such "resources, including management and financial resources...as will enable it to...comply in all respects with its obligations under this licence".
- 1.3. Ofgem's investigation concerns applications and offers for connection made between 1 July 2004 and 11 October 2010², and the monitoring systems that were in place at the time to ensure compliance with the obligations regarding connection offers.
- 1.4. CN has entered into a settlement agreement with Ofgem by which CN has agreed not to contest Ofgem's findings as set out in this proposed decision.
- 1.5. The Authority finds that:
 - CN did not have monitoring systems in place sufficient to enable it effectively to monitor compliance with its obligations under the electricity distribution licence between 1 July 2004 and the time of the introduction of a new system for connections in January 2009, in breach of SLC 30;
 - There have been 14 instances where CN has breached the three month timeframe required in SLC 12 when the time of the contravention took place on or after 9 December 2008³; and
 - There has been one case where CN has breached the three month timeframe required in SLC 12, and two cases where CN has breached the requirement set out in SLC 4D, when the time of the contravention took place before 9 December 2008.

¹ Prior to June 2008 the obligations under SLC 12 were contained in SLC 4D.

² This was the date on which Ofgem sent out its last information request to CN under section 28(2) of the Electricity Act 1989.

³ The Authority may not impose a penalty in respect of instances of breach where the time of the contravention was prior to 9 December 2008. This is because 9 December 2009 was the date on which Ofgem sent out its first information request to CN under section 28 (2). While the Authority can only impose a penalty in relation to breaches where the time of the contravention was on or after 9 December 2008, it is open for the Authority to find breaches which occurred previous to this point as a matter of fact.

- 1.6. The Authority considers it appropriate to impose a penalty on CN for these contraventions.
- 1.7. The Authority gives significant weight to CN's cooperation with Ofgem's investigation in this case including its willingness (and agreement) to settle this investigation, as well as to the actions CN had already taken to resolve the previous shortcomings in its systems.
- 1.8. In the circumstances, the Authority hereby gives notice under section 27A of the Electricity Act 1989 (the "Act") of its proposal to impose a penalty of £400,000 on CN in respect of contraventions of its licence conditions which the Authority considers took place in this case after 9 December 2008.
- 1.9. Any written representations on this notice must be sent to Dipen Gadhia at Ofgem (Dipen.Gadhia@Ofgem.gov.uk) by 28 February 2011.

2. Background

- 2.1. Distribution Network Operators are natural monopolies with respect to a number of services where it is more efficient for a single company to provide the service than it would be for several competing companies. Examples of such "non-contestable" activities carried out by DNOs include deciding the point of connection to the DNO's network and the design, approval and connection of extension assets to the DNO distribution system and their energisation. Contestable activities, such as the design, provision of equipment and construction of the contestable works, are open to other (accredited) third parties to complete the work for customers, and this has allowed competition to develop to varying degrees across the UK.
- 2.2. Given the significant levels of market share still maintained by DNOs, Ofgem considers it is important for customers that, where customers choose to have their connection provided by the incumbent DNO, the DNO provides offers for those services in accordance with the relevant licence condition. Ofgem's enforcement powers serve to provide an important incentive to DNOs to comply with their obligations.
- 2.3. On 3 August 2009 CN submitted its response to Ofgem's request for performance data as part of the Connections Industry Review for 2008-09. CN's response and the subsequent correspondence⁴ led to a concern that CN may have breached its obligation to provide timely connection offers set out in SLC 4D/12 in a number of cases in 2008 and 2009.
- 2.4. Throughout the investigation CN has argued that system limitations prevented it from demonstrating compliance with SLC 4D/12 in relation to 57 applications received between 2008 and the first quarter of 2009. CN has also told Ofgem that in five of those 57 cases there was evidence of human error that resulted in the offer being delivered late in breach of SLC 4D/SLC12.
- 2.5. On the basis of the evidence collected during the investigation Ofgem concluded that there was sufficient evidence to support a number of breaches of SLC 4D/12. Likewise, Ofgem considered that between 1 July 2004 and January 2009 CN did not have a robust system that would enable it to effectively monitor and demonstrate compliance with SLC 4D/12. Ofgem considers that this constituted a breach of SLC 30 which requires a licensee to have available sufficient resources, including

⁴ Ofgem queried CN's compliance with SLC 4D/12 and SLC 30 by means of 2 letters issued on 28 September 2009 and 23 October 2009.

management and financial resources, so that it can comply in all respects with its obligations under its licence.

- 2.6. In order to determine whether there were breaches of SLC 12 other than the 5 cases reported by CN, Ofgem carried out a review of the project files where the time of the contravention took place on or after 9 December 2009. On the balance of evidence, Ofgem considered that CN had breached SLC 12 in 14 cases within the penalty period. In addition, Ofgem's review of the information provided by CN throughout the investigation has indicated that there were three additional breaches of the three month timeframe (specifically, one breach of SLC 12 and two breaches of SLC 4D) where the time of the contravention occurred outside the penalty period.
- 2.7. The Authority notes that during the investigation it was not possible for Ofgem to determine the exact number of cases that may have occurred between 2004 and 2008 where CN failed to provide a connection offer within the three month period. This is because the weaknesses in CN's systems at the time prevented it from submitting an accurate and conclusive review of its performance over that period in a timely fashion without expending significant resource and potentially affecting its ongoing service to customers.
- 2.8. During the investigation, CN acknowledged that its previous processes and systems for managing connections activity (which had been replaced prior to the commencement of the investigation) had certain limitations which required improvement in order to enable it to monitor effectively its performance in relation to the provision of timely connection offers.
- 2.9. In January 2009 CN implemented a new system with additional functionalities which has enabled it to provide a more proactive monitoring of connection offers and to prevent further delays from happening. This system was the outcome of a business transformation plan initiated by CN in 2007.

3. The Authority's decision on whether to impose a financial penalty

General background to the Authority's decision to impose a financial penalty

- 3.1. The Authority has considered whether a financial penalty is appropriate in accordance with the requirements of the Electricity Act 1989 and with its published Statement of Policy ("Policy") with respect to Financial Penalties (October 2003).
- 3.2. The Authority is required to carry out all its functions, including the taking of any decision as to penalty, in the manner which it considers is best calculated to further its principal objective, having regard to its other duties. The Authority is not, under its own Policy, limited to consideration of matters specifically mentioned in the Policy, but will consider all the circumstances. The matters detailed in this policy are considered below.

Factors tending to make the imposition of a financial penalty more likely than not

Whether the contravention or the failure has damaged the interests of consumers or other market participants

- 3.3. The Authority finds that the general interests of consumers are likely to have been damaged by the contravention, although there is no specific evidence of this in this case. Compliance with the provision to provide offers as soon as reasonably practicable, and in any event within three months, is an important service and means of protection for customers who require certainty over the time of connection offers in order to deal with the costs associated with managing project schedules.

Whether imposing a financial penalty is likely to create an incentive to compliance and deter future breaches

- 3.4. The Authority considers that imposing a financial penalty on CN is likely to incentivise compliance and help deter future breaches by sending a message to the company, its shareholders and the industry at large that a failure to deliver services under the licence obligations will not be tolerated.

Factors tending to make the imposition of a financial penalty less likely than not

If the contravention is trivial in nature

- 3.5. The Authority considers that the contraventions cannot be described as "trivial". As a result of CN's failure to have appropriate monitoring systems in place to ensure compliance, there are 57 cases between 2008 and July 2009) where the time taken between the receipt of application for connection and the issue of the connection offer exceeded the statutory maximum of three months and CN was unable to demonstrate compliance. Moreover, due to the weaknesses in CN's systems at the time, there is also uncertainty as to the exact number of instances where CN might have failed to provide a connection offer within the three month timescale between 2004 and 2008.

That the principal objectives and duties of the Authority preclude the imposition of a penalty

- 3.6. There is nothing in the Authority's principal objective and duties to preclude the imposition of a penalty in this case.

That the breach or possibility of a breach would not have been apparent to a diligent licensee

- 3.7. The Authority considers that if CN had had adequate systems and processes in place, as is expected from a diligent licensee, it would have been in a position both to comply and to demonstrate compliance with SLC 4D and SLC 12 at any time. During the investigation CN accepted that its systems and processes at the time had limitations, and that this is the main reason why it was unable to both demonstrate compliance in a number of reported cases and also to provide, in a timely fashion without expending significant resource and potentially affecting its ongoing service to customers, an accurate review of its performance from 1 July 2004, which is the time when the three month requirement entered into force.
- 3.8. In light of the above, the Authority considers it appropriate to impose a financial penalty in this case.

4. Criteria relevant to the level of financial penalty

- 4.1. Under the Electricity Act 1989 the Authority may impose a financial penalty of up to 10 per cent of the annual turnover of the relevant licence holder. Annual turnover is defined in Regulations issued by the Secretary of State⁵. The Regulations allow the inclusion of all revenue from the activities of the licence holder, whether regulated or not. In the year ended 31 March 2010 CN had a combined turnover of £677m according to the Regulatory Accounts. On this basis, the maximum fine leviable is £67.7m.

⁵ The Electricity and Gas (Determination of Turnover for Penalties) Order 2002.

- 4.2. In arriving at the quantum of the penalty in this case, the Authority has considered the following factors in accordance with its Policy. It notes that the factors set out in its Policy do not preclude the Authority considering other factors. It has also taken the view that it may consider potential harm under this section of its Policy, and that the potential for harm will be part of the reason why the relevant condition was imposed in the first place. Given the nature of this case, the potential harm has not been an important factor in determining the level of the penalty.

Factors which are first considered when determining the level of penalty

The seriousness of the contravention and failure

- 4.3. It is the Authority's view that the contravention is of a serious nature. CN still account for the significant majority of all connections work in its area. In addition, CN is funded under the existing price control to deliver good customer service and the licence obligations reinforce this.
- 4.4. Compliance with the licence obligations is an important part of the integrity of monopoly network regulation. Ofgem expects that licensees deploy sufficient resources on systems, processes or mechanisms in order to ensure that they comply with the licence obligations. Ofgem maintains that these obligations include the effective monitoring and review of the time taken to provide connection offers.
- 4.5. CN has stated that it is unable to demonstrate compliance with SLC 4D/12 in 57 cases between 2008 and July 2009. The Authority considers there is sufficient evidence to support 14 breaches of the three month timescales within the penalty period. In addition CN has not been able to provide an accurate review of its performance regarding its obligation to provide connection offers within the three month period back to 2004, because it lacked appropriate systems to monitor compliance with such obligations during the period in question. In Ofgem's view, all of the above is indicative of the seriousness of the breach.

The degree of harm or increased cost incurred by customers or other market participants after taking into account any compensation paid

- 4.6. The Authority believes that it is likely that there was some harm to consumers as a result of CN's contravention. However, Ofgem was not able to determine this with certainty during the investigation.

The duration of the contravention or failure

- 4.7. The Authority considers that there are at least 14 breaches of SLC 12 where the time of the contravention occurred on or after 9 December 2008. As explained above, the evidence collected by Ofgem during this investigation suggests that CN is unable to demonstrate compliance with SLC 4D and SLC 12 in 57 cases between 2008 and July 2009. Furthermore, CN was unable to determine, in a timely fashion without expending significant resource and potentially affecting its ongoing service to customers, the exact number of cases between 2004 and 2008 where it might have failed to provide a connection offer within the three month period. The Authority therefore considers that there was an ongoing breach of SLC 30 from July 2004 to January 2009, which is when CN implemented a new system to manage connection offers.

The gain (financial or otherwise) made by the licensee

- 4.8. It is apparent from the arguments and the evidence presented in the SOC that CN was unable to meet the service standards prescribed in its licence because it did not have systems and processes in place sufficient effectively to monitor compliance. To

the extent that having these systems and processes in place involves the commitment of company resources, or additional opex or capex expenditure, there is an element of avoided cost associated with CN's failure to comply.

Factors tending to increase the level of penalty

Repeated contravention or failure

- 4.9. There have been repeated contraventions in this case – a total of 14 breaches of SLC 12 within the penalty period and three breaches outside the penalty period. In addition, there are 57 reported cases between 2008 and July 2009 where CN acknowledges that it is unable to demonstrate compliance with SLC 4D/12 due to systems limitations at the time.

Absence of any evidence of internal mechanisms or procedures intended to prevent contravention or failure

- 4.10. The Authority notes that CN has acknowledged that it could not confirm whether there had been breaches of the licence condition relating to the provision of connection offers between 2004 and 2008, as its systems at the time were not set up to monitor compliance adequately.

The involvement of senior management in any contravention or failure

- 4.11. The Authority considers that senior management were not involved in any deliberate actions in relation to the contraventions or failures.

The extent of any attempt to conceal the contravention or failure from Ofgem

- 4.12. After the matter had been drawn to its attention, CN did not attempt to conceal the contravention from Ofgem.

Factors tending to decrease the level of penalty

Co-operation with Ofgem's investigation

- 4.13. CN has co-operated fully with Ofgem over the course of the investigation by providing Ofgem with detailed information, both on a voluntary basis and in response to formal information requests. CN also attended two meetings with Ofgem staff where issues relating to the investigation were discussed. Because CN decided not to contest Ofgem's findings, Ofgem did not have to expend additional resources on responding in detail to CN's comments on the SOC and on preparing for an oral hearing. The Authority also gives weight to CN's willingness (and agreement) to settle this investigation on the basis of this proposed decision.

Appropriate action by the licensee to remedy the contravention or failure

- 4.14. The Authority notes that in January 2009 CN introduced a new system for managing connections offers work. The Authority notes that CN voluntarily started working on this system in 2007 which is well before Ofgem opened the investigation. Also, since becoming aware of the failures regarding the three month requirement CN has implemented additional measures in order to reinforce their systems and processes aimed at improving customer service.

5. The Authority's proposed decision

- 5.1. The Authority proposes to impose a financial penalty on CN of £400,000 which it considers is reasonable in all the particular circumstances of this case. This represents 0.06% of the company's licensed turnover and 0.5% of its connections revenue.⁶ The penalty is a lower figure than would have been imposed if the company had contested Ofgem's findings.
- 5.2. Any representations or objections with respect to the Authority's proposal must be made, preferably by email, before 28 February 2011 to :
Dipen.Gadhia@Ofgem.gov.uk (postal address, Ofgem, 9 Millbank, London SW1P 3GE).
- 5.3. The Authority would prefer it if, as far as possible, responses were provided in a form that can be placed on the Ofgem website. Should you wish your response or part of your response to remain confidential, please indicate this clearly.

Gas and Electricity Markets Authority

7 February 2011

⁶ Based on regulatory accounts year ended 31 March 2010.