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29 February 2012

Dear Anna,

DRAFT ENFORCEMENT GUIDELINES ON COMPLAINTS AND INVESTIGATIONS

I am writing in response to the letter from Megan Forbes dated 16 December 2011 inviting comments on Ofgem's review of its approach to enforcement.

Part 1 of Ofgem's review is a consultation on proposed updates to the Enforcement Guidelines. We have summarised our response to this consultation in the body of this letter, with further detail in Appendix 1. Part 2 is a wholesale review of Ofgem's approach to enforcement, taking a fundamental look at procedures and policy. Our response to the call for evidence in support of Part 2 is given in Appendix 2.

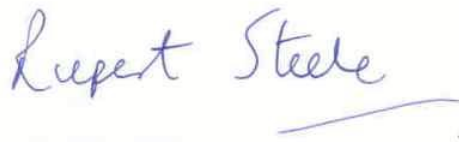
Our main comments on the proposed updates to the Enforcement Guidelines are as follows:

- **Settlement procedure (early resolution):** Enforcement investigations can have significant resource and cost implications for both licensees and Ofgem. We are therefore fully supportive of the introduction of a settlement procedure that would reduce this burden and enable early resolution. We believe the draft guidelines on the settlement procedure would benefit from greater clarity on the following aspects:
 - the criteria for determining whether an investigation is suitable;
 - how and when Ofgem would expect to advise the licensee of the case against it and likely magnitude of a penalty;
 - the circumstances under which normal rights of appeal may or may not apply to an agreed settlement;
 - Ofgem's approach to consultation on an agreed settlement.

- **Oral representations and decision making:** There does not appear to be any opportunity for a licensee to have a dialogue with members of the Authority on its view and rationale for the size of any financial penalty as part of the oral representation process. It would be helpful if the statement of case were to include (or be accompanied by) an indication of the range of financial penalties being considered, and the reasoning behind them. The magnitude of the potential penalty will be a material factor in the licensee's decision how vigorously to challenge the statement of case and whether to accept the offer of an oral hearing. Early communication of the potential penalty would save time for both the licensee and for Ofgem.

I would be pleased to discuss further any of the points raised above or within the attached appendices and provide further information that may be required.

Yours sincerely,

A handwritten signature in blue ink that reads "Rupert Steele". The signature is written in a cursive style and is positioned above a horizontal line that serves as a separator.

Rupert Steele
Director of Regulation

Appendix 1: Comments on draft enforcement Guidelines

Settlement Procedure

The current enforcement formal investigation procedure can have significant resource and cost implications for both licensees and Ofgem. It can take time to reach a conclusion and creates operating uncertainty during the investigation period. We are therefore fully supportive of a settlement procedure that would reduce the existing procedural burden and allow early resolution.

We are broadly comfortable with the approach to settlement set out in the draft guidelines. In particular, we believe the ‘without prejudice’ status is helpful in facilitating constructive dialogue. However, we would suggest four areas in which it could be improved:

a) Transparency on the criteria for suitability of the Settlement Procedure

Ofgem mentions in the consultation that it may not be ‘desirable’ to reach early resolution unless a case is ‘appropriate’. It would be helpful to set out in the enforcement guidelines the main criteria that will be used in assessing whether a case is suitable for the settlement procedure – recognising that it may not be possible to provide for every circumstance that might arise. This would improve transparency and credibility, and may increase the uptake of the procedure.

We consider the matters raised under this paragraph a) and c) below are closely linked.

b) Financial impact – Level of financial penalty and communication during the Settlement Procedure

The guidelines suggest that “before starting discussions, Ofgem will need to be satisfied that it has sufficient information to enable it to assess the nature and extent of the breaches, the likely detriment caused, and the level of penalty that might be appropriate” (paragraph 4.28).

For the settlement procedure to be effective, it is important that Ofgem share as much as possible of this information with the licensee at an early stage, so that both parties enter the negotiations with realistic expectations of the range of possible outcomes. It will be particularly helpful for Ofgem to provide a view on the level of penalty that it would consider appropriate, together with clear and case-specific reasoning. Whilst we realise that the figure may change as the process progresses, an initial view on the approximate level of financial penalty should be possible. Similarly, the guidelines suggest that the quicker a settlement can be reached, the more significant any reduction in penalty will be. Again, some reference criteria for reducing a penalty would be helpful.

We believe that there will be instances where, as part of the settlement protocol; Ofgem should be willing to forego its rights to seek to impose a penalty in the event that a settlement is reached. This is likely to lead to agreement in a shorter timescale.

c) The right of appeal

Our understanding of the Settlement Procedure is that the normal rights of appeal following the imposition of financial penalty may not always apply. Post settlement, the impact of Ofgem decisions relating to other licensees, who are being investigated for the same breach or infringement, could impact the considered fairness or appropriateness of the Settlement. The industry would benefit from the development of further guidance within the enforcement guidelines regarding the circumstances under which normal rights of appeal may or may not apply to settlements.

d) Consultation following settlement

Ofgem's guidelines are silent on the procedure following conclusion of the settlement, in particular whether Ofgem would expect to consult on the nature of the settlement. Whilst it is clearly desirable in the context of formal enforcement proceedings for Ofgem to consult on its proposed determination, as this allows suppliers (and other interested parties) a mechanism for input into the Ofgem determination of the case, we do not believe that it is as straightforward in cases of early settlement.

In this situation, Ofgem expects suppliers to effectively admit to a breach of their obligations as part of the settlement procedure and they will then settle the case on this basis. If following this, a formal consultation takes place and changes are subsequently required, this could potentially weaken a supplier's legal position and create further reputational damage. Indeed, if matters cannot be resolved on a "full and final" basis then licensees are likely to be reluctant to seek a negotiated settlement with Ofgem, particularly in more significant matters.

Provisional Orders

We recognise that a Provisional Order can be used during an enforcement investigation, in order to cease or correct a behaviour that could be detrimental to consumers, whilst an investigation is still in progress. However, such orders should be used with caution, to deal with the risk of serious and irreversible harm to consumers. It is appropriate for Ofgem to satisfy itself, in relation to any provisional order, that such an approach would be proportionate and that the licensee is likely to be able to comply with the order. It would therefore normally be good practice for Ofgem to consult with the licensee before making any provisional order.

Consumer protection legislation

The inclusion of detail on existing Ofgem powers of enforcement under Part 8 of the Enterprise Act is a useful addition to Ofgem's guidance documentation related to enforcement procedures.

We support the enforcement regime that is set out within the Enterprise Act 2002. What is particularly encouraging is the emphasis on two way contact in an attempt to secure compliance, before any formal enforcement activity is undertaken. This approach is particularly important when dealing with legislation that may require further guidance to support understanding or where its interpretation is not straightforward.

Criteria for opening an investigation

It would be helpful for licensees to have visibility of complaints and other information that Ofgem considers may be worthy of investigation, but which, for reasons of priority, Ofgem has elected not to investigate further for the time being. Provision of such information, along with any supporting evidence, would enable licensees to investigate and take any necessary corrective action without the need for Ofgem involvement.

Making a complaint

The information in the draft guidelines will be useful to any potential complainant. We are not sure however whether a complainant would attempt to access the information through any published enforcement documentation. Consumer group stakeholders may however welcome the clarification.

Oral representations and decision making

The opportunity for oral representation can be used by a licensee to explain in more detail the rationale for its actions, a differing perspective, the details of any mitigation activity, etc, and this might help increase understanding of the written representation before the Authority makes a final decision on the case.

However, there does not appear to be any opportunity for a licensee to have a dialogue with members of the Authority on its view and rationale for the size of any penalty that it deems appropriate for a proven compliance failure.

It would be helpful if the statement of case were to include (or be accompanied by) an indication of the range of financial penalties being considered, and the reasoning behind them. The magnitude of the potential penalty will be a very material factor in the licensees decision how vigorously to challenge the statement of case and whether to accept the offer of an oral hearing. Early communication of the potential penalty could save time for both the licensee and for Ofgem.

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Appendix 2: Call for Evidence for wider review of enforcement: ScottishPower response

Introduction

We fully agree that Ofgem has an important role to protect the interests of consumers and to ensure the effective functioning of the energy market. There is significant stakeholder and public scrutiny on our market and we all have a responsibility to consumers, to ensure that they are treated fairly in all of our dealings with them. It is clear that Ofgem is responsible to ensure that licensees are held to account for failures that ultimately impact on the fair treatment of consumers and the functioning of the market.

Prominence given to ongoing enforcement activity

Ofgem notes that the level of enforcement activity has increased significantly over the last year and we recognise that, in a period when consumer trust is low, undertaking visible enforcement action can give stakeholders confidence that the regulator is holding market participants appropriately to account. However, a balance needs to be struck in terms of the profile given to this activity. Constant allusion to investigations and alleged breaches of obligations (particularly before investigations have concluded) may reinforce negative perceptions of the sector and further erode consumer trust

Two stage enforcement

We believe that two stage enforcement approaches are inherently superior as they put problem resolution ahead of conflict and avoid any incentive for defensive behaviours by companies when a regulator raises a potential compliance issue. In particular, as discussed in our responses to the Retail Market Review consultations, we believe that a move by Ofgem towards principles-based licence requirements will only be workable if it is accompanied by a two stage enforcement regime.

Other regulators who favour a principles based approach have recognised that there are constraints on how far and how fast an industry can move towards principles based regulation¹. It is recognised that this approach has to be underpinned by supporting materials and industry guidance. There will be a degree of judgement required to ascertain whether the approach and intention of a company's measures to ensure compliance against principles based regulation has been appropriate, on the basis of supporting documentation.²

The key feature of an at least two stage enforcement regime is that licensees are given a reasonable opportunity to remedy any breach before they become liable for a penalty or enforcement order. For example, a useful precedent is the bespoke enforcement regime that Ofgem introduced for Condition 25A (Prohibition of undue discrimination in supply), which normally has three stages³:

Stage 1: Ofgem writes to the Supplier, giving it an opportunity to respond and provide objective justification for a suspected breach.

¹ FSA, Principle Based Regulation, Focussing on the outcomes that Matter, April 2007, page 2

² FSA, Principle Based Regulation, Focussing on the outcomes that Matter, April 2007, page 14

³ 'Guidelines on Cost Reflectivity between Payment Methods and the Prohibition of Undue Discrimination in Domestic Gas and Electricity Supply Contracts', Ofgem, 7 August 2009, p19.

Stage 2: If Ofgem is not satisfied with the response, it writes to the Supplier explaining why it is not satisfied and allowing the Supplier a reasonable time to respond; if, at this stage, the Supplier revises its pricing, Ofgem is unlikely to take further action, unless there is evidence of a persistent failure to comply.

Stage 3: If the Supplier does not revise its pricing, Ofgem will make the case for a licence breach and continue enforcement in line with existing Enforcement Guidelines, potentially leading to a financial penalty and/ or an enforcement order.

Although Ofgem will normally follow this approach, it is not constrained by its guidance to do so, and reserves the right in exceptional circumstances to proceed directly to enforcement action.

Similar approaches are also employed by other regulators. For example, the Communications Act 2003 sets out a two stage enforcement process which Ofcom must follow in enforcing telecommunications regulations:

Stage 1: Following an investigation, Ofcom issues a 'Section 94' notification explaining why it considers there has been a contravention and giving a deadline (normally one month) to remedy any ongoing contravention;

Stage 2: If the company does not comply with the Section 94 notification, Ofgem may issue a 'Section 95' enforcement notification and may also impose a financial penalty under Section 96.

We would encourage Ofgem to adopt a similar enforcement approach for the Standards of Conduct licence conditions as it has for Condition 25A – and for any other principles based regulations that may be adopted in future. This would mitigate any unintentional differences in interpretation of the high level principles between Ofgem and suppliers.

Whilst we recognise that some serious breaches could require an immediate formal enforcement approach, we believe that this should be subject to a high threshold, especially where the regulation is of a general nature that is open to interpretation. Formal enforcement would not be an appropriate response to a reasonable difference in interpretation of a general principle. Failure by licensees to take action resulting from previous discussions could also be an appropriate reason for early formal enforcement.

Informal dialogue

Whilst we recognise the important role of formal enforcement, it is clear that the formal enforcement route can take a significant period of time to conclude and is a drain on the resources of all parties involved in an investigation. We welcome the fact that Ofgem is trying to put in place alternative mechanisms to alleviate the time and impact of this process through the introduction of the Settlement Procedure, but believe that more could be done in conjunction with licensees to ensure that consumer protection is proactively addressed, rather than reactively remedied.

Ofgem is making increased use of written communication alerting licensees to emerging areas of regulatory concern, where Ofgem considers licensees may not be doing enough to ensure compliance or where there may be differing views over the interpretation of regulations (eg the open letter on Objections contained within the Non-domestic Retail Market Review).

We welcome this approach. Having early sight of such issues allows licensees to investigate and address these concerns internally. We accept that if licensees are given sufficient opportunity to address these concerns and then subsequently do not demonstrate a willingness to improve business performance, further more formal enforcement action may be required.

This has parallels with a practice often adopted by Ofcom, where it opens an 'own-initiative investigation' into industry-wide compliance with a regulatory obligation. An example is the enforcement programme to monitor compliance by broadband providers with obligations relating to change of supplier⁴. Although such investigations may be conducted under formal enforcement powers (which facilitates information gathering), there is an expectation that if any non-compliance with regulations is detected, these will be discussed with the companies concerned who will be given a chance to remedy them. Only if companies fail to take action would an enforcement order be issued against them. This approach is best suited to new areas of regulation or areas where understanding of best compliance practice is evolving, where the regulator's activity can help spread best practice and 'level-up' compliance.

There is also a partial precedent in Ofgem's proposed approach to enforcing consumer protection legislation, where Ofgem engages in dialogue with companies before any move towards formal enforcement action.

If the enforcement team were to have periodic discussions with licensees in addition to the above, the concept of early warning could go further and become more effective. Expending this time proactively should then negate the requirement for the same volume of investigations. If this approach were to invoke quicker corrective action from licensees, this in turn would have quicker benefits for consumers, decreasing potential market and consumer harm.

Ofgem website - investigations

Information on investigations in Ofgem's website is divided into two parts:

- 'current investigations': a heading and brief paragraph detailing the target of the investigation, the relevant regulation, and the nature of the alleged breach;
- 'closed investigations': a list of documents issued following closure of investigations.

Information on current and closed investigations plays a key role in industry compliance. It gives licensees an insight into the way that Ofgem has interpreted licence conditions and the approach it adopts in investigating them. It contributes to transparency and confidence that licensees are being treated even-handedly. And when one licensee has been found in breach, it serves to put the others 'on notice'.

It would be helpful if Ofgem could consider revamping the 'closed investigations' section of its website to include potted histories of all closed investigations, with links to supporting documents where appropriate. The potted histories could build on the content in the 'current investigations' section, giving details of the timescales, findings and any enforcement action taken. The 'current investigations' section would also benefit from progress updates summarising key developments in the investigation.

⁴ Ofcom Enforcement Report, 12 May 2009, page 18

A good example of how this can be done effectively is Ofcom's 'Competition and Consumer Enforcement Bulletin'⁵.

Marketing and intermediaries

One aspect of the current licensing and enforcement landscape that remains troublesome is the fact that third parties participating in the energy supply market place have a different set of regulatory obligations than the suppliers that they are in effect competing with. This can lead to some distortions and should be borne in mind by Ofgem when considering its approach to enforcement.

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⁵ <http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/>