

Notice of intention to impose a financial penalty pursuant to section 30A of the Gas Act 1986

Proposal of the Gas and Electricity Markets Authority to impose a financial penalty, following an investigation into the failure by Wales & West Utilities Limited to comply with Standard Special Conditions A40(5), D9(2), D9(5)(c), and Special Conditions E2B, E20(3)(a) and (b) and E20(7)(a) of its gas transporter licence (the "licence")

6 July 2012

1. Summary

- 1.1 The Gas and Electricity Markets Authority ("the Authority") proposes to impose a financial penalty of £375,000 on Wales & West Utilities Limited ("WWU") following an investigation into WWU's compliance with Standard Special Conditions A40(5), D9(2), D9(5)(c), and Special Conditions E2B, E20(3)(a) and (b) and E20(7)(a), of its gas transporters licence.
- 1.2 In accordance with its licence, WWU is required to provide Ofgem for each regulatory year a report of the gas main decommissioning work completed by WWU in that year.
- 1.3 The ability of regulators to rely on accurate information from regulated companies is a fundamental part of the regulatory regime. The Authority therefore regards any contraventions of the obligations on accurate reporting of regulatory information as serious.
- 1.4 The investigation concerned WWU's establishment and maintenance of systems of control relating to revenue and cost reporting, and to the measurement and recording of gas main decommissioning information, for the years 2005-06 to the present, and its regulatory reporting for the years 2005-06, 2006-07 and 2008-09.
- 1.5 The Authority finds that WWU failed to comply with Standard Special Conditions A40(5), D9(2) and D9(5)(c), and Special Conditions E2B(8)(3)(b), E20(3)(a) and (b) and E20(7)(a) of its gas transporters licence during the relevant periods. These conditions relate to misreporting and to the failures to maintain appropriate system, set out in more detail in section 3 below.
- 1.6 WWU has advised Ofgem that it has carried out its own thorough investigations and assurance procedures and it has assured Ofgem that it considers it has taken all reasonably practicable steps to establish whether there are any further instances of misreporting, and found none. Ofgem will take a very serious view of any further instances of misreporting that may, despite WWU's assurances, come to light. WWU has also told Ofgem that it has improved its systems and it considers that it now has systems in place to ensure accurate reporting in accordance with its licence. WWU will, within six weeks of the publication of the final penalty notice in this case, also provide Ofgem with a review of the risks associated with its processes and systems related to mains decommissioning and set out any steps it will take to address any remaining significant risks. For this risk assessment it will use the high level approach which Ofgem has developed as

part of the current RIIO price control reviews, taking into account further development of this approach by the electricity distribution companies¹.

- 1.7 The Authority considers it appropriate to impose a financial penalty on WWU for those contraventions of WWU's licence conditions taking place on and after the appropriate statutory limitation date, namely 16 November 2009, being 12 months prior to Ofgem's first information request dated 15 November 2010.
- 1.8 In the circumstances, the Authority hereby gives notice under section 30A(3) of the Gas Act 1986 ("the Act") of its proposal to impose a penalty of £375,000 on WWU in respect of its failure to comply with Special Conditions E20(3)(a) and (b) and Standard Special Condition A40(5) of its gas transporters licence relating to the period 16 November 2009 onwards. In deciding on the level of the penalty, the Authority has taken into account WWU's willingness to engage and co-operate with Ofgem and, in particular, its work to isolate incidents of historic misreporting, the improvements to processes it has made, and its agreement to conclude this investigation at an early stage. The proposed level of penalty would otherwise have been higher.
- 1.9 Any written representations on the proposed penalty must be received by Emily Thoo at Ofgem (emily.thoo@ofgem.gov.uk) by 5.00pm on 27 July 2012.
- 1.10 Any representations received that are not marked as confidential may be published on the Ofgem website. Should you wish your response or part of your response to remain confidential, please indicate this clearly.

2. Background

- 2.1 WWU is conducting an HSE-approved programme to decommission certain spun, cast and ductile iron gas pipes within 30m of buildings within its gas distribution networks in order to reduce the risk of pipe fracture and the resulting gas releases and risks of explosions. WWU recovers the efficiently incurred costs of undertaking its activities, including the pipe decommissioning programme, by levying distribution charges on gas shippers, which are ultimately passed on to customers.
- 2.2 As part of the price control process, Ofgem sets the maximum allowed revenue the companies can pass through the regulated component of their distribution charges. A component of this is revenue associated with the pipe decommissioning programme where distribution network operators are funded for the amount of pipe decommissioned. As such, accurate reporting of pipe decommissioning and replacement activities is essential to Ofgem in reviewing the distribution network operators' allowed revenues.
- 2.3 WWU voluntarily informed Ofgem on 15 October 2010 that there had been errors in its regulatory reporting of distribution decommissioning/replacement data. On 6 December 2010, in response to Ofgem's information request, to which it responded on time, it confirmed this and advised that it had discovered a total of four cases leading to misreporting overall. These were:
 - In the 2005-06 year, 100m of 10" spun iron pipe were misrecorded as decommissioned.

¹ See

<http://www.ofgem.gov.uk/Networks/Documents1/Network%20Licensee%20Data%20Compliance%20Report%20Final.pdf>

- Separately, also in the 2005-06 year, 222m of 4" asbestos² and 461m of 4" spun iron pipe were misrecorded as decommissioned.
- In the 2006-07 year, 383m of 4" spun iron pipe were misrecorded as decommissioned, and 24 service replacements were also misclaimed.
- In the 2008-09 year, 88m of 4" spun iron pipe were misrecorded as abandoned.

The aggregate overclaim of allowed revenue as a result of these projects was less than £63,500 (compared with an overall corresponding aggregate allowed revenue of £753 million). However, work carried out to complete the necessary decommissioning abandonment during the calendar year 2010 had an aggregate "matrix" value of around £100,000 for the reporting years 2009-10 and 2010-11 which WWU did not claim.³ Hence, WWU did not receive more money for this activity than it should have. The lengths of pipe misreported as replaced and consequent effect on allowed revenues are small. However, the Authority considers that contraventions of this nature are serious matters due to Ofgem's reliance on the accuracy of regulatory information to carry out its functions.

- 2.4 Although Ofgem's investigation concentrated primarily on WWU's conformance with licence conditions that regulate mainly economic and efficiency criteria, we considered that some of the issues under consideration may have had some wider safety implications. Since the Health and Safety Executive (HSE) has primary responsibility for safety, Ofgem has liaised closely with them on this matter.
- 2.5 HSE has reviewed the circumstances of this case and WWU's subsequent remedial actions. HSE considers that the failures did not of themselves give rise to significant risk and so, in the circumstances, no further HSE action was justified as regards health and safety.

3 The Contraventions

Misreporting of decommissioning statistics (before 1 April 2008)

- 3.1 The Authority found that WWU had breached Special Conditions E2B(8)(3)(b), and Standard Special Conditions D9(5)(c) of its licence as follows:
- In its regulatory reporting pack for the financial year 2005-06 (submitted to Ofgem on 31 July 2006), WWU reported that the total length of main decommissioned in that year was 383.293km. In fact, the work to decommission 0.783km of this total had not been done so WWU should have reported 382.510km.
 - In its regulatory reporting pack for the financial year 2006-07 (submitted to Ofgem on 31 July 2007), WWU reported that the total length of main decommissioned in that year was 402.844km. In fact, the work to decommission 0.383km of this total and to transfer 24 services had not been done.

Misreporting of decommissioning statistics (after 1 April 2008)

- 3.2 The Authority found that WWU had breached Special Condition E20(7)(a) of its licence as follows:

² Asbestos pipes do not form part of the HSE iron pipe decommissioning programme, but statistics relating to decommissioned asbestos pipes should be included in WWU's Regulatory Reporting Pack.

³ Under the terms of Gas Distribution Price Control Review, the Gas Distribution Networks were allowed a fixed unit cost per metre of main abandoned based on different diameters. These unit costs are multiplied through by the length of main abandoned to give an overall allowance for the total mains decommissioned. This referred to as the matrix value.

- In its regulatory reporting pack for the financial year 2008-09 (submitted to Ofgem on 31 July 2009), WWU reported that the total length of mains decommissioned in that year was 439.110km. In fact, the work to decommission 0.088km of this total had not been done.

Failure to maintain adequate systems, processes and procedures in the mains replacement programme (before 1 April 2008)

- 3.3 The Authority found that WWU breached Standard Special Condition D9(2) of its licence by its failure to put in place and maintain appropriate systems, processes and procedures for accurately recording lengths of main decommissioned. From FY 2005-06 until 31 March 2008, WWU was required by Standard Special Condition D9(2) of its licence to “establish appropriate systems, processes and procedures to measure and record [mains decommissioning information]”.

Failure to maintain adequate systems, processes and procedures in the mains replacement programme (after 1 April 2008)

- 3.4 The Authority found that WWU breached Special Conditions E20(3)(a) and (b), Standard Special Condition A40(5) of its licence by its failure to put in place and maintain appropriate systems, processes and procedures for accurately recording lengths of main decommissioned. From 1 April 2008, starting with the reporting year 2008-09, WWU was required:
- By Special Condition E20(3)(a) of its licence, which has a focus on revenue reporting, to establish and maintain appropriate systems, processes and procedures to measure and record specified information in respect of the Formula Year commencing 1 April 2008 and for each subsequent Formula Year in accordance with the revenue reporting regulatory instructions and guidance (including any associated information therein) for the time being in force pursuant to this condition. Reference is made to the Regulatory Instructions and Guidance (RIG) relating to price control revenue reporting published, following consultation, by Ofgem on 25 June 2009.
 - By Special Condition E20(3)(b) of its licence, which has a focus on revenue reporting, to maintain all systems of control and other governance arrangements that ensure that information collected and reported to the Authority is in all material respects accurate and complete and that all such systems of control and other governance arrangements are kept under regular review by the directors of the licensee with a view to ensuring that they remain effective for this purpose.
 - By Standard Special Condition A40(5) of its licence, which has a focus on cost reporting, to maintain all systems of control and other governance arrangements that (a) ensure that information collected and reported to the Authority is in all material respects accurate and complete and (b) ensure that ... all such systems of control and other governance arrangements are kept under review by the directors of the licensee with a view to ensuring that they remain effective for this purpose.
- 3.5 WWU has admitted 4 incidents leading to 3 cases of misreporting, which were small in absolute terms of length (1.254 km against 1225.248 km abandoned in total in the relevant years). These only came to light as a result of reports of gas escapes from the general public, which then initiated WWU’s other monitoring systems. This, along with consideration of evidence of the systems in place from 2005 until more recently, derived from Ofgem’s detailed investigation, has led the Authority to conclude that WWU breached all the above seven licence conditions.

Steps taken to address problems

- 3.6 WWU has informed us that it has undertaken a significant amount of work to establish whether there have been any other incidents leading to misreporting: reviewing over 180 other projects in which the individuals involved in the discovered incidents had participated; reviewing over 162,000 cases where gas mains had been accessed over the past 6 years; reviewing 38,000 closed cases where errors in asset recordings had been reported; and asking for and receiving a letter of assurance from all staff to disclose any instances of misreporting, with an amnesty from disciplinary action if they did so. WWU has informed Ofgem that it considers it has taken all reasonably practicable steps to establish whether there are any further instances of misreporting, and found none. Ofgem will take a very serious view of any further instances of misreporting that may, despite WWU's assurances, come to light.
- 3.7 The Authority notes that WWU has taken a number of steps to address these problems and secure compliance, starting before the opening of the Ofgem investigation. In particular, WWU has advised Ofgem of the steps it has taken to revise its processes, procedures and project documentation, including duplicates of certain key documents and strong new emphasis on individual accountability for work undertaken and recorded. It has also introduced audit checks to monitor compliance with these requirements, both identifying and correcting errors, and also reinforcing the serious view that is taken by WWU of any non-compliance with the procedures, including through disciplinary action where appropriate.
- 3.8 WWU will, within six weeks of the publication of the final penalty notice in this case, also provide Ofgem with a review of the risks associated with its processes and systems related to mains decommissioning and set out any steps it will take to address any remaining significant risks. For this risk assessment it will use the high level approach which Ofgem has developed as part of the current RIIO price control reviews, taking into account further development of this approach by the electricity distribution companies⁴.

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

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

- 4.1 The Authority has considered whether a financial penalty is appropriate in this case, taking into account the requirements of the Act and its published Statement of Policy with respect to Financial Penalties (October 2003) ("the Policy").
- 4.2 The Authority is required to carry out all of its functions, including the taking of any decision as to financial penalty, in the manner which it considers is best calculated to further its principal objective and having regard to its other duties.
- 4.3 In deciding whether it is appropriate to impose a financial penalty, the Authority has considered all the circumstances of the case including, but not limited to, the specific matters set out in the Policy. These matters are examined in detail below.

⁴ See

<http://www.ofgem.gov.uk/Networks/Documents1/Network%20Licensee%20Data%20Compliance%20Report%20Final.pdf>

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

- 4.4 For Ofgem to carry out its functions effectively, the accurate reporting of information to it by regulated companies is crucial. Misreporting or inaccurate reporting of regulatory information by any regulated company has the potential to lead to allowances being granted under the price control laid down by Ofgem which are not justified by the underlying activity. This would potentially damage, at least initially, the interests of direct customers (e.g. gas shippers) and also of consumers, who are among the ultimate purchasers of the gas.
- 4.5 The Authority has found that the identified cases of misreporting relate to small values in the context of WWU's overall mains replacement programme and revenues. However, we note that WWU's failure to maintain adequate systems, processes and procedures means that in other circumstances the position could have been different – and indeed, given the problems identified with WWU's systems, it is not possible for Ofgem to ascertain for itself that there have not been other, undiscovered instances of misreporting. However WWU has conducted its own investigations and it has given Ofgem assurances that it considers it has taken all reasonably practicable steps to establish whether there are any further instances of misreporting, and found none. Ofgem will take a very serious view of any further instances of misreporting that may, despite WWU's assurances, come to light.

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

- 4.6 Misreporting or inaccurate reporting of regulatory information by any regulated company is difficult for Ofgem to detect and may lead to significant detriment to other market participants and to consumers should it go undetected. It is therefore necessary that regulated entities are deterred from misreporting or inaccurate reporting and are incentivised to ensure that its systems, processes and procedures are adequate to ensure accurate reporting of regulatory information. The Authority considers that the imposition of penalties where misreporting and inaccurate reporting comes to light, as in this case, is likely to create an incentive to compliance for the industry and deter future breaches.

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

Whether the contravention is of a trivial nature

- 4.7 The lengths of pipe misreported as replaced and consequent effect on revenues are small. However, the Authority does not consider that the contraventions are trivial in nature, due to Ofgem's reliance on the accuracy of regulatory information to carry out its functions.

The principal objective and duties of the Authority preclude the imposition of a penalty

- 4.8 There is nothing in the Authority's principal objective and duties that precludes the imposition of a penalty in this case.

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

- 4.9 Much publicity has been given to the need for accurate reporting by regulated entities in recent years. WWU was made aware by Ofgem in 2006 of regulatory

decisions taken by Ofwat⁵ in relation to misreporting, and corresponded with Ofgem, providing assurances as to the accuracy and integrity of its regulatory reporting.

- 4.10 The Authority considers that licensees were on notice of the importance of ensuring compliance in this area and should have had in place adequate systems and controls to ensure that the breaches of its licence (as found by the Authority) did not occur. Ofgem thus considers that the breach or possibility of a breach would have been apparent to a diligent licensee.

Conclusion

- 4.11 After consideration of the above, the Authority concludes that it is appropriate to impose a financial penalty in this case.
- 4.12 By virtue of section 30C(1) of the Act, as it applies in this case, the Authority may not impose a penalty in respect of contraventions of WWU's licence conditions which took place more than 12 months prior to the date of Ofgem's first Information Request of 15 November 2010. Accordingly, the Authority has decided only to impose a penalty in respect of WWU's contraventions of its licence conditions which took place from 16 November 2009.

5. Criteria relevant to the level of financial penalty

- 5.1 In accordance with section 30A(1) and 30A(8) of the Act, the Authority may impose a financial penalty which, respectively, must be "of such amount as is reasonable in all the circumstances of the case" and must not exceed 10 per cent of the annual turnover of the relevant licence holder. Annual turnover is defined in an Order issued by the Secretary of State⁶ as the applicable turnover for the business year preceding the date of this notice. In the business year ending on 31 March 2011 WWU's turnover was £312,800,000, therefore the maximum penalty that can be applied in this case is £31,280,000.
- 5.2 In deciding the appropriate level of financial penalty, the Authority has considered all the circumstances of the case, including the following specific matters set out in the Policy.

Factors which are first considered when determining the level of financial penalty

The seriousness of the contravention and failure

- 5.3 The Authority considers that the contraventions in this case are serious. Ofgem relies on the submission of accurate information by regulated entities in order to enable Ofgem to carry out its statutory functions and to set the charges which WWU may levy from its customers. Ofgem also relies on its ability to make comparisons and measure relative performance in costs and delivery of outputs.
- 5.4 Misreporting or inaccurate reporting of regulatory information by WWU has the potential to lead to charges, set pursuant to Ofgem's price controls, which are not justified by WWU's underlying activities, and therefore may lead to unjustified charges being levied by WWU from its customers. This may have knock-on detrimental effects on consumers who are among the ultimate purchasers of the gas distributed by WWU. The instances of admitted misreporting and analysis of

⁵ The Water Services Regulation Authority

⁶ The Electricity and Gas (Determination of Turnover for Penalties) Order 2002.

evidence produced by WWU demonstrate that WWU has failed to maintain adequate systems, processes and procedures in its mains replacement programme, to ensure accurate regulatory reporting. Paragraphs 4.4 and 4.5 set out the Authority's finding in respect of any damage to consumers and other market participants.

- 5.5 The importance of accurate reporting by regulated entities as well as instances of misreporting in other sectors were expressly brought to WWU's attention in a letter from the Chairman of the Authority, Sir John Mogg – now Lord Mogg – in July 2007. WWU gave assurances to Ofgem in response about the quality and integrity of WWU's regulatory reporting and robustness of its systems of internal controls and external assurance. WWU was therefore aware of the need for accurate regulatory reporting and adequate internal systems. Moreover, the Authority considers WWU's failure to maintain adequate systems, to prevent misreporting or inaccurate reporting, to be serious, because the misreporting or inaccurate reporting which may result is itself serious.

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

- 5.6 Paragraphs 4.4 and 4.5 set out the Authority's finding in respect of any damage to consumers and other market participants.

The duration of the contravention or failure

- 5.7 The Authority considers that it is relevant to take into account the duration – over several years – of the contraventions in respect of the maintenance of adequate systems. Such contraventions occurred from 2005/2006 until more recently when, following the discovery by WWU of the misreporting incidents in 2010, changes made by WWU have started to come on stream during 2010 and 2011. These changes are intended to underpin the assurances given by WWU as to the improvement of its systems, its confidence that all past failures have been discovered and as to the delivery of accurate reporting in future.

The gain (financial or otherwise) made by the licensee

- 5.8 There has been no net gain to WWU (see paragraph 2.3) from the misreporting or inaccurate reporting in this case in terms of money received for the mains replacement programme. However, the Authority notes that GDNs are funded as part of their regulated revenue to maintain adequate systems to ensure accurate reporting. By failing to put these in place, WWU avoided expenditure that could be considered required of a GDN. However it is noted that WWU has now put in place such improved systems and, also, that it has not claimed for the remedial costs of the further abandonment works undertaken since these problems came to light.

Factors tending to increase the level of financial penalty

Repeated contravention or failure or continuation of a contravention or failure after either becoming aware of the contravention or failure or becoming aware of the start of Ofgem's investigation

- 5.9 The Authority does not find that WWU continued the contravention after becoming aware of it, or after the start of Ofgem's investigation. However, the Authority considers it relevant to take into account that WWU did make repeated inaccurate reports to Ofgem during reporting years 2005-06, 2006-07 and 2008-

09, which is evidence that its failure to maintain adequate systems subsisted for a number of years.

The involvement of senior management in any contravention or failure

- 5.10 The Authority does not consider that senior management was involved in any deliberate actions in relation to the contravention. However, the Authority considers that ensuring adequate systems to prevent misreporting or inaccurate reporting were the responsibility of senior management at WWU.

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

- 5.11 There were some internal mechanisms to prevent contravention or failure in place but the Authority considers that the mechanisms in place during the relevant period were insufficient to ensure compliance with the licence conditions.

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

- 5.12 WWU did not attempt to conceal the contravention.

Factors tending to decrease the level of financial penalty

The extent to which the licensee had taken steps to secure compliance either specifically or by maintaining an appropriate compliance policy, with suitable management supervision

- 5.13 The Authority acknowledges that WWU had taken some steps to secure compliance following transfer of the relevant licence to WWU in 2005. However, it is the Authority's opinion that these were not appropriate for ensuring the required standard was reached. Further steps have now been taken by WWU to secure compliance with licence requirements as set out at paragraph 3.7.

Appropriate action by the licensee to remedy the contravention or failure

- 5.14 In an effort to secure future compliance with the licence conditions, WWU took the steps set out in paragraph 3.7.

Evidence that the contravention or failure was genuinely accidental or inadvertent

- 5.15 While there is no evidence that the contravention was wilful, the contravention cannot be regarded as genuinely accidental or inadvertent as it was within WWU's control to allocate resources appropriately, to ensure adequate systems, processes and procedures.

Reporting the contravention or failure to Ofgem

- 5.16 WWU first notified Ofgem of misreporting in October 2010, and confirmed all of the known incidents in its response to Ofgem's Information Request in November 2010. Ofgem would expect companies to report cases of potential misreporting promptly. However, approximately 10 months elapsed from January 2010, when WWU made its first discovery of a misreporting incident, before Ofgem was notified of this.

Co-operation with Ofgem's investigation

- 5.17 WWU has co-operated fully with Ofgem's investigation and has admitted the contraventions. WWU's decision not to contest Ofgem's findings and pursue the matter to an oral hearing has resulted in a saving of time and resources for Ofgem. The Authority has given weight to WWU's willingness to engage with Ofgem and its agreement to settle the investigation on the basis of this decision.

6. The Authority's decision

- 6.1 The Authority hereby proposes to impose a financial penalty on WWU of £375,000 which it considers is reasonable in all the circumstances of the case.
- 6.2 The penalty is a much lower figure than would have been imposed if WWU:
- had not fully co-operated with Ofgem's investigations;
 - had contested Ofgem's findings and pursued the matter to an oral hearing;
 - had not taken proactive steps to investigate matters internally and to introduce various new controls and measures to ensure future compliance.
- 6.3 Any written representations on the proposed penalty must be received by Emily Thoo at Ofgem (emily.thoo@ofgem.gov.uk) by 5.00pm on 27 July 2012.
- 6.4 Any representations received that are not marked as confidential may be published 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

6 July 2012