

Notice of intention to impose a financial penalty pursuant to section 27A(3) of the Electricity Act 1989 and section 30(A)(3) of the Gas Act 1986

Proposal of the Gas and Electricity Markets Authority to impose a financial penalty, following an investigation into compliance by Scottish Power Energy Retail Limited with the gas and electricity standard licence condition 27.2A

20 May 2014

1. Summary

- 1.1. The Gas and Electricity Markets Authority ("the Authority") proposes to impose a financial penalty on Scottish Power Energy Retail Limited ("SP") following an investigation into SP's compliance with condition 27.2A of the gas supply standard licence conditions and condition 27.2A of the electricity supply standard licence conditions (collectively referred to as "SLC 27.2A").
- 1.2. SLC 27.2A requires that any differences in terms and conditions (including prices and discounts) between different payment methods reflect the difference in costs to the supplier of those payment methods.
- 1.3. This provision is extremely important since, as Ofgem stated in its guidelines on the interpretation and enforcement of inter alia SLC 27.2A¹, it is to prevent material detriment being caused to customers "*and in particular, detriment to vulnerable groups*". Compliance with SLC 27.2A is therefore essential to protect consumers.
- 1.4. Moreover, SLC 27.2A implements the requirements of the Second Energy Package,² which requirements have since been re-enacted in the Third Package Directives of the European Commission, that:

"Any difference in terms and conditions shall reflect the costs to the supplier of the different payment systems".³
- 1.5. Taking action for non-compliance and imposing a penalty which is effective, proportionate and dissuasive contributes to Ofgem's fulfilment of its objectives as the national regulatory authority.⁴
- 1.6. The Authority finds that SP breached SLC 27.2A in the period since it came into force on 1 September 2009 until 2 December 2012 ("the Relevant Period") by not having a sufficiently robust process in place which ensured that the price (and discounts) differentials were compliant with SLC 27.2A. Notably, SP did not have a sufficiently robust view of the relative costs of the different payment methods.
- 1.7. The Authority makes no findings for the period from 2 December 2012 onwards. It notes that the differential between SP's direct debit and standard credit tariffs reduced significantly after that date.
- 1.8. The Authority is satisfied that SP has agreed to take and is taking appropriate steps for the purpose of securing compliance with SLC 27.2A. In particular, it has

¹ "Guidelines on Cost Reflectivity and Undue Discrimination" (Ref: 102/09). (The Guidelines)

² Electricity Directive (2003/54/EC), Article 3, paragraph (5), and Annex A (d) and Gas Directive (2003/55/EC), Article 3, paragraph (5), and Annex A (d).

³ Gas Directive (2009/73/EC), Annex 1, paragraph 1(d) and Electricity Directive (2009/72/EC), Annex 1, paragraph 1(d).

⁴ Gas Directive, Article 40 and Electricity Directive, Article 36.

improved its internal processes to set terms and conditions in order to ensure that its differentials are compliant with SLC 27.2A. The Authority is therefore not making an enforcement order in this case.

- 1.9. The Authority considers it would have been appropriate to impose a penalty on SP. However, SP have agreed to make a payment of £750,000 to Energy Best Deal Extra. The Authority considers that the payment (with a nominal penalty of £1) will be of greater benefit to energy consumers than if a penalty was imposed.
- 1.10. The Authority therefore hereby gives notice under section 27A(3) of the Electricity Act 1989 and section 30A(3) of the Gas Act 1986 of its proposal to impose a penalty of £1 on SP in respect of contraventions of SLC 27.2A in the Relevant Period. The level of the penalty is lower than it would have been but for the steps taken by SP to improve their processes and the agreed settlement of this investigation.
- 1.11. Any written representations on the proposed penalty must be received by Merce Almuni at Ofgem merce.almuni@ofgem.gov.uk or Ofgem, 9 Millbank, London, SW1P 3GE) by **5 pm on 17 June 2014**.
- 1.12. 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. The Authority introduced SLC 27.2A into the standard conditions of the gas and electricity supply licences. The licence condition came into effect on 1 September 2009. SLC 27.2A requires that:

"Any differences in terms and conditions as between payment methods for paying Charges for the supply of [gas/electricity] shall reflect the costs to the supplier of the different payment methods."

- 2.2. In this context, terms and conditions include price, discounts and any other terms and conditions which vary by payment method.
- 2.3. If a licensee intends to set different terms and conditions for different payment methods, the licensee must have a robust process in place which ensures that those differences are compliant with SLC 27.2A. Notably, the licensee must have a sufficiently robust view of the relative costs of the different payment methods.
- 2.4. In addition to the licence conditions, in August 2009 Ofgem published guidelines setting out the principles Ofgem intended to take into account when interpreting and applying SLC 27.2A. The Guidelines remain in effect insofar as they concern SLC 27.2A⁵.
- 2.5. The Authority's objective was to better implement the requirements of the Second Energy Package,⁶ which requirements have since been re-enacted in the Third Energy Package Directives of the European Commission published in 2009, the purpose of which is to ensure that consumers are fully protected and to ensure that:

⁵ Licence Condition 25A included a "sunset clause", and lapsed after three years of its introduction.

⁶ Electricity Directive (2003/54/EC), Article 3, paragraph (5), and Annex A (d) and Gas Directive (2003/55/EC), Article 3, paragraph (5), and Annex A (d).

"...all consumers, especially vulnerable ones, can benefit from competition and fair prices..."; and

"different payment systems should be non-discriminatory."⁷

- 2.6. Moreover, Ofgem launched a study of the state of the energy supply markets in Great Britain (GB) (the Probe) in February 2008. Ofgem was concerned with the functioning of competition in GB electricity and gas retail supply markets for domestic and Small and Medium Enterprise (SME) consumers. The Probe⁸ identified that unjustified price differentials and discriminatory pricing structures had had a significant detrimental impact on the consumers affected, with a disproportionate impact on vulnerable groups.⁹
- 2.7. In November 2010, Ofgem launched another review into the state of the energy retail market in GB. The review was launched to assess the progress which suppliers had made in responding to the Probe remedies. In particular, Ofgem analysed the suppliers' compliance with SLC 27.2A. Ofgem's findings from that review highlighted¹⁰ that SP's price differential between standard credit and direct debit payment methods was very high and substantially out of line with that of other market participants.
- 2.8. In March 2011 Ofgem opened a formal investigation in order to determine whether SP was complying with the obligations of SLC 27.2A.

3. The Authority's decision on contraventions

- 3.1. During the Relevant Period, SP charged different prices and set different discounts for supplying gas and electricity on a "dual-fuel" basis to customers paying their accounts by the standard credit and direct debit payment methods.
- 3.2. Based on the sum of evidence in its possession, the Authority finds that during the Relevant Period SP failed to take sufficient steps at the time that it set the prices to ensure that the differentials between standard credit and direct debit prices and discounts were compliant with SLC 27.2A.
- 3.3. When determining whether there had been a contravention of SLC 27.2A, the Authority considered whether SP had a robust process which ensured that the price and discounts differentials between those payment methods were compliant with the licence condition, as explained in paragraph 2.3.
- 3.4. The Authority's view is that compliance with SLC 27.2A requires consideration of the costs associated with providing a service to particular customer groups. The Guidelines state that costs that can be attributable to particular products and services can be used to justify price differentials. The Guidelines also state that working capital and revenue collections costs, and a premium for bad debt can be appropriate justifications for price differentials between payment types. This consideration of costs must be made when the supplier is setting prices and must use appropriate and relevant inputs.

⁷ Gas Directive (2009/73/EC), Preamble, paragraph (47) and Electricity Directive (2009/72/EC), Preamble, paragraph (50).

⁸ As explained in the "The Energy Supply Probe Initial Findings Report" (Ref 140/08) published on 6 October 2008.

⁹ Vulnerable consumers are defined in the Probe.

¹⁰ These findings are published in the "The Retail Market Review - Findings and initial proposals" (Ref 34/11) published on 21 March 2011.

- 3.5. The Authority considered whether SP had a robust forward-looking view of the relative costs of each of the relevant payment methods at the time when the licence condition came into force on 1 September 2009 and at the times when SP decided on the level of price changes for the different payment methods during in the Relevant Period. During the Relevant Period SP's changed prices (and increased its price differentials) on 25 November 2010 and 1 August 2011¹¹.
- 3.6. SP provided information to Ofgem in the course of its investigation in relation to the areas described in paragraph 3.4 that it identified as differing materially by payment method. The Authority considered each of these differing costs in relation to the Relevant Period.
- 3.7. It was not possible for the Authority to determine whether during the Relevant Period the price differentials set by SP were compliant or not. However, by failing to have a robust process in place which would ensure that the differences in prices and discounts were compliant, there was a risk that prices and discounts differentials set by SP during the Relevant Period were not compliant. In any event, as explained in 3.3 and 3.4, SP should have had a robust process which ensured that the price and discounts differentials were compliant with SLC 27.2A at the time the prices were set.
- 3.8. During the course of the investigation, SP admitted to Ofgem that the processes it had used during the Relevant Period did not provide a robust forward looking view of the relative costs of different payment methods.
- 3.9. Based on the sum of evidence in its possession, the Authority has found that at the time that the licence condition came into force and until the subsequent price increase in November 2010, SP did not have in place an appropriate forward-looking view of the relative costs of different payment methods.
- 3.10. Moreover, SP did not provide Ofgem with sufficient contemporaneous documents showing how it had set different prices and discounts in respect of each of the payment methods, and how this had ensured that those differentials were compliant, including the forward looking view of the costs of each of the relevant payment methods.
- 3.11. The Authority considers that SP should hold contemporaneous documents which demonstrate that, at the time of setting new prices and discounts, their differentials were compliant.
- 3.12. The Authority therefore concludes that SP breached SLC 27.2A during the Relevant Period by not having a robust process in place which ensured that the price and dual fuel discounts differentials were compliant with SLC 27.2A.

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. Under section 27A(1) of the Electricity Act 1989 and section 30A(1) of the Gas Act 1986, where the Authority is satisfied that a licence holder has contravened or is contravening any relevant condition or requirement, then it may impose a penalty of such an amount as is "*reasonable in all the circumstances of the case*".

¹¹ There was a further price increase on 3 December 2012 which was after the end of the Relevant Period. See paragraph 1.7.

- 4.2. In considering whether it would be appropriate to impose a penalty and, if so, what level of penalty, the Authority must have regard to the Statement of Policy with respect to financial penalties (“the Policy”).¹²
- 4.3. 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. The principal objective is to protect the interests of existing and future customers in relation to electricity conveyed by distribution or transmission systems and in relation to gas conveyed by pipes.
- 4.4. In concluding the imposition and appropriate level of penalty in this notice, the Authority has taken full account of the particular facts and circumstances of the contraventions under consideration including, but not limited to, the specific matters set out in the Policy. These matters are examined in detail 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

- 4.5. The European Commission, in its Gas and Electricity Directives¹³, places obligations on national regulatory authorities such as Ofgem to ensure, amongst other things, that all final consumers and in particular vulnerable consumers are protected.
- 4.6. The European Commission determined that the interest of consumers would be damaged unless:

“Any difference in terms and conditions [reflected] the costs to the supplier of the different payment systems.”
- 4.7. Licence Condition 27.2A was designed to reflect the EU Directives addressing these concerns.
- 4.8. Moreover, in the Probe, Ofgem identified that unjustified price differentials and discriminatory pricing structures have had a significant detrimental impact on the consumers affected, with a disproportionate impact on vulnerable groups.¹⁴
- 4.9. On the available evidence, the Authority made no finding that any specific consumer harm resulted from SP’s failure to have sufficient processes in place during the Relevant Period.¹⁵

¹² “The Statement of Policy with respect to financial penalties” October 2003.

<https://www.ofgem.gov.uk/ofgem-publications/74207/utilities-act-statement-policy-respect-financial-penalties.pdf>

¹³ Directive 2009/72/EC (the Electricity Directive) and 2009/73/EC (the Gas Directive) of the European Parliament and the Council of 13 July 2009.

¹⁴ See the “The Energy Supply Probe Initial Findings Report” (Ref 140/08) published on 6 October 2008. The Probe identified that Standard Credit customers are amongst the least active in the market. That is, they are less likely to change tariffs or payment methods, and are also less likely to switch suppliers. Therefore, they are likely to be impacted financially by differential pricing that is not compliant with SLC 27.2A.

¹⁵ In its Guidelines, Ofgem indicated that it would not consider any terms and conditions to be an infringement of SLC 27.2A unless a materiality threshold was met (Guidelines, paragraph 5.1.). In determining materiality, Ofgem will take into account relevant considerations including the timing of price changes, scale and degree of impact on consumers and detriment to vulnerable groups (Guidelines, paragraph 5.3). The Guidelines address situations where it is possible to assess the cost reflectivity of the terms and conditions on offer. The materiality threshold does not apply in cases where, as a result of a lack of appropriate processes, such an assessment is not possible.

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

- 4.10. It is essential that gas and electricity suppliers are incentivised to have processes in place to ensure that when they set prices, the price differentials are compliant with SLC 27.2A. In their absence, gas and electricity suppliers risk damaging the interests of consumers, in particular of vulnerable consumers.
- 4.11. The Authority considers that the imposition of a penalty in this case is likely to deter future breaches by SP and other market participants by emphasising the need to put in place a process to ensure compliance with SLC 27.2A.

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

Whether the contravention is trivial in nature

- 4.12. The Authority considers that SP's contraventions of SLC 27.2A are not trivial. The breaches relate to a failure to put in place a robust process for complying with an obligation which Ofgem had made clear was an important measure for protecting consumers and, in particular, vulnerable consumers.

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

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

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

- 4.14. It was SP's responsibility to ensure that it had in place a process to ensure that its price differentials were compliant with SLC 27.2A. The Authority considers that a diligent licensee would have devoted sufficient resources to put in place a process to ensure compliance with its licence obligations.
- 4.15. In addition, the Authority considers that the contravention should have been apparent to SP.
- 4.16. The Authority therefore considers it appropriate to impose a financial penalty on SP.

5. Criteria relevant to the level of financial penalty

- 5.1. In accordance with section 270(1) of the Electricity Act 1989 and section 300(1) of the Gas Act 1986, 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 an Order issued by the Secretary of State for Energy and Climate Change¹⁶ as the applicable turnover for the business year preceding the date of this notice. In the year ending on 2013, SP had a turnover of £4,119 million.¹⁷

¹⁶ The Electricity and Gas (Determination of Turnover for Penalties) Order 2002.

¹⁷ Accessed via:

http://www.scottishpower.com/userfiles/document_library/ScottishPower_Segmental_Generation_and_Supply_Statements_2013.pdf

- 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 penalty

The seriousness of the contravention and failure

- 5.3. SP failed to have in place processes which ensured that prices (and discounts) differentials were compliant with SLC27.2A. This provision is an important protection for consumers, particularly vulnerable consumers and robust processes are required to reduce the risk of harm to these consumer groups. Therefore, the Authority considers that SP's breach of its licence condition is serious.

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

- 5.4. As explained in paragraph 4.5 to 4.8, SLC 27.2A aims to protect the interests of consumers, in particular vulnerable consumers. In the absence of robust processes, there is a possibility that SP's customers may have incurred increased costs. However, the Authority was unable to establish that SP's customers incurred increased costs as a result of the breach.

The duration of the contravention or failure

- 5.5. The Authority determined that SP was not in compliance with SLC 27.2A during the period from September 2009 – December 2012, a period of just over three years. The Authority makes no finding in respect of the period after December 2012. It notes that the differential between SP's standard credit and direct debit tariffs reduced significantly after that date.

The gain (financial or otherwise) made by the licensee

- 5.6. The Authority finds that, by failing to have a robust process in place to ensure that price differentials were compliant, there is a risk that SP made a financial gain. However, it was not possible for the Authority to establish whether SP did in fact make such a gain as a result of the breach.
- 5.7. The Authority considers that SP may have gained financially from the avoidance of administrative costs that would have been incurred if the appropriate processes had been put in place.

Factors tending to increase the level of penalty

Repeated contravention or failure or a continuation of failure after being aware of the contravention

- 5.8. The investigation started in March 2011. SP increased prices in August 2011. The Authority has found that even after being made aware of the Authority's belief that a breach of SLC 27.2A may have occurred, SP did not use processes that would ensure that the price differentials were compliant when setting prices during the Relevant Period.

The involvement of senior management in any contravention or failure

- 5.9. The Authority has seen no evidence that senior management at SP were involved in any deliberate actions in relation to the breaches described above. However, it

is the Authority's opinion that it is the responsibility of senior management at SP to ensure that proper processes were in place and to monitor the use of those processes to ensure compliance with its licence conditions.

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

5.10. The Authority found no evidence that there was any attempt to conceal the contraventions.

Factors tending to decrease the level of 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

5.11. The Authority finds that SP failed to have an adequate process in place in order to secure compliance with SLC 27.2A. To comply with its obligations under SLC 27.2A, SP should have had a process in place. The Authority has seen no evidence that any other policy was in place in order to secure compliance with these provisions.

5.12. SP stated that their process to set prices was supervised by management. However, as explained in Section 3, the Authority found that SP's policies did not go far enough in order to ensure compliance with SLC 27.2A.

Appropriate action taken by licensee to remedy the contravention or failure

5.13. SP has now taken steps to secure compliance with its licence obligations, by improving its process in order to secure SLC 27.2A compliance at the time when SP sets its prices.

Evidence that the contravention or failure was genuinely accidental or inadvertent

5.14. While there is no evidence that the contravention was deliberate or wilful, the contravention cannot be regarded as accidental or inadvertent as it was within SP's control to set up robust processes that would ensure compliance with this licence condition.

Reporting the contravention or failure to Ofgem

5.15. SP did not report the contravention to Ofgem.

Co-operation with Ofgem's investigation

5.16. The Authority notes SP's willingness to admit these breaches through settlement and the commitments it has made to put in place measures to remedy these breaches through the course of the investigation.

5.17. During the investigation there were some problems with the provision of information and with the revision of previously submitted information, which delayed the conclusion of this investigation. However the agreement to settle and the remedies put in place have shortened the length of the investigation.

5.18. The Authority also noted SP's willingness to agree to make payments to Energy Best Deal Extra, which will benefit energy consumers.

6. The Authority's decision

- 6.1. The Authority hereby proposes to impose a financial penalty on SP of £1 which it considers to be reasonable in all the circumstances of the case. The penalty is a lower figure than would have been imposed if SP:
- had not been willing to engage with Ofgem during the settlement process;
 - had SP not provided an admission of liability; and
 - had not SP made the offer of payment of £750,000 to Energy Best Deal Extra.
- 6.2. Any written representations on the proposed penalty must be received by Merce Almuni at Ofgem (merce.almuni@ofgem.gov.uk or Ofgem, 9 Millbank, London, SW1P 3GE) by **5pm on 17 June 2014**.
- 6.3. 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

20 May 2014