To all stakeholders

ofgem
Making a positive difference
for energy consumers

6 November 2014

Dear stakeholder

Financial penalties and consumer redress policy statement

On 31 March 2014 we published a consultation on the Authority's proposed financial penalties and consumer redress policy statement for enforcement cases under the Gas Act and Electricity Act. We received 17 responses which are on our website.[1]

Overall, the responses highlighted broad support for:

- the objectives we proposed to promote when using these powers
- calculating penalties in a more prescriptive way
- the factors we said we would consider in setting penalty levels
- the remedies we think should be available under redress orders.

This letter sets out the Authority's position on the key points made by stakeholders. It also outlines the main changes to the policy statement that the Authority has decided to make as a result of the consultation.

Regulatory objectives

As noted above, there was broad support for the objectives that the Authority proposed to pursue when considering whether and how to use its penalties and redress powers. Some respondents wanted more clarity about how the Authority's better regulation duties would affect how we use our penalties and redress powers.

Our response

The Authority has decided to retain the regulatory objectives that it proposed in March. The Authority will indeed have regard to the principles of best regulatory practice but it is not possible to set out in advance precisely how these principles will affect individual enforcement decisions. The policy statement now makes clear that the Authority[2] will have regard to its better regulation duty in considering each case (just as we have had regard to the duty in drawing up the policy statement itself). We have also clarified that, when determining a reasonable penalty, we will consider the level of any consumer redress ordered and/or which is being or has been provided.

[1] We received responses from British Gas, Citizens Advice Service, Cooperative Energy, Ecotricity, EDF, Electricity Northwest, Energy UK, Good Energy, National Grid, Northern Gas Networks, Northern Powergrids, Ombudsman Services, npower, Scottish Power, SSE, UKPN and a domestic energy consumer.
[2] In practice, the Enforcement Decision Panel to whom the Authority has delegated decision-making powers.

One respondent said that when using our enforcement powers, we should ensure fair competition among market participants and that penalty levels should reflect the extent to which other market participants have been disadvantaged.

Our response

Competition impacts are included in our case opening criteria in the new Enforcement Guidelines.[3] The Enforcement Oversight Board will therefore be able to consider those impacts, among other things, when deciding whether to open or continue a case.

As far as the policy statement is concerned, we have already stated our intention to assess the seriousness of the breach when setting the penal element. The policy statement is explicit that this assessment may include a consideration of the impacts on both the market as a whole and on individual market participants. We believe that this gives decision-makers enough flexibility to take account of disadvantage suffered by market participants when setting the amount of a penalty. We have not therefore made any changes to the policy statement.

Determining the amount of a penalty

Respondents agreed that the total financial liability of a company should normally comprise two elements, the amount of detriment and/or gain to be removed from the regulated person (and if practicable returned as redress to consumers) and a penal element reflecting the seriousness of the breach and the need for deterrence.

Our response

The Authority has decided to adopt the process set out in section 5 of the policy statement. This is based on calculating the two elements of the total financial liability for a company.

Several respondents wanted confirmation that they would have an opportunity to influence any proposals that an investigation team would be sending to the Settlement Committee. They said that if companies did not have sufficient opportunity to make representations on the alleged breaches and the calculation of detriment, this would reduce the chances of reaching a settlement within the early settlement window.

Our response

Companies will be given an opportunity to respond in writing and in person to the case team's Summary Statement of Initial Findings. For further detail see the Enforcement Guidelines and associated decision document[4] that we published on 12 September 2014.

Calculating detriment and gain

Several respondents were concerned that Ofgem might double count consumer detriment in the redress and penal elements.

Our response

We have clarified in the policy statement that when determining a reasonable penalty, we will consider the level of any redress ordered and/or which is being or has been paid by a company.

[3] https://www.ofgem.gov.uk/ofgem-publications/89753/enforcementguidelines12september2014publishedversion.pdf.
[4] https://www.ofgem.gov.uk/ofgem-publications/89755/enforcementguidelinesdecisiondocument12september2014publishedversion.pdf.

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

Where the Authority is satisfied that adequate redress has been or is being provided, the final penalty and/or final redress ordered to be paid by the regulated person will take this into consideration. In this context, the Authority will consider the interests of consumers and accordingly will:

- *consider the efforts that have been made by the regulated person to direct the redress to the affected consumers and whether the redress fully reflects the loss, damage or inconvenience caused*

- *take into account any payments to the affected consumers that may already have been made, for example under statutory standards of performance, other regulatory obligations or as a result of action taken by the Energy Ombudsman.*

We consider that it is appropriate to ensure that companies do not gain from non-compliance and to ensure that consumers receive adequate redress for any loss, damage or inconvenience they have suffered. We also consider that it is appropriate to take financial harm into account when assessing the seriousness of a breach.

Some respondents said suppliers should be permitted to pay the penal element in the form of additional consumer redress, for example, as additional payments to an appropriate charity, trust or organisation, or goodwill gestures to the affected customers.

Our response

This is an option that would only be available as part of a voluntary redress package and only if the Authority considered that it was in the interests of consumers to do so.

Assessing the seriousness of breaches

Some respondents said that we should classify each kind of potential breach in advance according to its level of seriousness. For example, one stakeholder requested guidance on what breaches are most serious.

Our response

We do not intend to classify breaches in advance. Apparently similar breaches can vary widely in their effects and what is most serious may vary over time. In addition, it may not be easy to judge accurately the seriousness of a breach we have not previously considered until we have seen the impact of the breach in practice. We do, however, in paragraphs 5.11 to 5.14 of the policy statement, outline the particular characteristics of a breach (in terms of its nature and impact) that make it more or less serious.

Several respondents said that on transparency grounds we should set out penalty ranges expressed in millions of pounds or percentages of turnover for breaches of differing levels of seriousness.

One respondent welcomed the process that the Authority proposed to adopt to calculate the penalty, but said that penalty notices should give a breakdown of the penalty calculation at each stage of the process.

Our response

The Authority has decided not to adopt penalty ranges. This is because penalty ranges involve a high level of prescription that would reduce the Authority's discretion over setting the level of penalties in individual cases. In addition, where the impact of penalties for similar breaches could vary greatly from company to company, fixed ranges could hamper the Authority's ability to impose a penalty that is reasonable in all the circumstances of the case. This will better enable the Authority to reflect the

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

individual circumstances of each case and to adapt to changes in industry behaviour over time.

We will therefore maintain our approach in calculating the penalty in the round to ensure that the penalty is reasonable in each case. As penalties will be calculated in the round, we will not detail a breakdown of the calculation at each stage of the process but will focus on the final amount.

Some respondents said the assessment of seriousness should be driven primarily by the number of consumers affected, the level of harm and whether or not the breach was the result of systemic, repeated failings or was a one-off accident.

Our response

We consider that the policy statement adequately allows decision-makers to take these factors into account in the assessment of seriousness and through considering the aggravating and mitigating factors. We would note, however, that the Authority reserves the right to impose penalties where a small number of customers are affected and/or if no harm has arisen as a result of the breach, but where there was a risk that harm could have arisen. This is necessary to ensure that there are strong incentives on companies to comply with their regulatory obligations.

Aggravating and mitigating factors

Some respondents said our policy statement should give more weight to self-reporting.

Our response

The Authority has always recognised the value of companies promptly reporting to us any non-compliance that they have identified. On 27 March 2014, we published a letter from the Chairman of the Authority on future financial penalties[5], which said that the Authority would continue to recognise the value of reporting (and putting right) any non-compliance.

The policy statement now cites "promptly, accurately and comprehensively" reporting a breach to Ofgem as one of the factors that tend to decrease any penalty that is imposed. The Authority has decided to insert this additional text in the policy statement to make clear that it attaches significant value to self-reporting and that greater credit will be given to prompt, accurate and comprehensive reporting.

In addition, the Authority has decided to amend paragraph 5.22 to make clear that in cases where the likelihood of detection was low (or would be low in future similar cases), the Authority will not on that basis apply a deterrence uplift if the breach was first brought to our attention by self-reporting.

We therefore expect companies to be prompt in reporting when a potential breach is uncovered, and prompt, accurate and comprehensive in reporting further information which comes to light. Further information about the Authority's views on self-reporting is in paragraphs 3.5-3.6 of the revised Enforcement Guidelines and paragraphs 1.48-1.52 of the associated decision document.

Respondents said that a lack of evidence of systems in place should not be an aggravating factor and that it would bear most heavily on small suppliers.

[5] https://www.ofgem.gov.uk/ofgem-publications/86815/theauthoritypositiononfuturefinancialpenaltiesletter27march2014.pdf.

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

Our response

We believe that the aggravating and mitigating factors now in the policy statement are sufficiently flexible to enable us to address the concerns raised. For example, a lack of evidence of systems may increase the penalty but decision-makers can make any allowances they deem reasonable bearing in mind the specific facts of a particular case.

One respondent sought clarification about what was meant by "full cooperation" given that cooperation is mentioned in the lists of both aggravating and mitigating factors.

Our response

The Authority expects companies to cooperate fully with Ofgem investigations. This is essential so that Ofgem can deal with cases efficiently and deliver the Authority's Vision and Strategic Objectives for enforcement. As set out in our Enforcement Guidelines, we will facilitate this in various ways, for example by providing case-specific timelines and, where appropriate, by discussing with companies the content and timing of information requests before we send them to companies formally.

On that basis, we expect that companies should be well placed to respond to all requests for information in a timely and constructive manner. In line with this, the Enforcement Guidelines decision document noted that we expect companies to set aside or make available adequate resources to handle an investigation efficiently.

If a company believes that it cannot fulfil any request made by an investigation team, it should tell us promptly and give a full explanation. If a company causes any unnecessary delays to the investigation by not cooperating fully, the decision-maker may treat this as an aggravating factor and consider whether it is appropriate to increase the penalty.

By contrast, the Authority considers that the mitigating factor should apply only where such cooperation has gone well beyond what would be expected of any regulated person facing enforcement action. Only in those circumstances will the Authority consider a reduction in penalty. In light of this, we have amended the final bullet of paragraph 5.17 to make it clear that a company's cooperation must go well beyond merely meeting prescribed timetables for responding to information requests or a Statement of Case.

Deterrence

Respondents acknowledged that it is legitimate for the Authority to consider whether to increase a penalty in order to deter future breaches. One said that penalising one company as a deterrent to all was disproportionate.

Our response

Except as noted above in relation to the self-reporting of hard to detect breaches, the Authority has decided not to amend the material in the policy statement on deterrence. Consistent with its Strategic Objectives for enforcement, and with the approach taken by other regulators, the Authority is determined that any penalty should be set at a level that will deter future non-compliance and incentivise compliance by all companies.

One respondent said that the Authority was unlikely to impose a financial penalty so large that it would affect a company's overall financial position. This respondent also said the Authority should instead take action that would affect the reputation of non-compliant companies in such a way that could affect their position in the market.

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

Our response

The Chairman's letter of 27 March 2014 signalled that the Authority intended to place greater value on deterrence in future financial penalties. This is likely to mean a substantial increase from the levels of penalty it has typically imposed to date. However, the Authority will also consider the other sanctions available to it in order to ensure visible and meaningful consequences for companies that fail consumers and do not comply. For example, the Authority's new consumer redress powers enable it to require a company to do anything that the Authority considers is necessary to remedy a contravention or prevent a similar one in future. This could, for example, involve requiring a company to draw attention to its failings by making it apologise. The Authority will in each case consider the precise balance of financial and reputational sanctions that would best protect the interests of consumers in line with the legislation.

Settlement discounts

Respondents supported introducing a system of fixed percentage discounts for settling cases. However, some said that the proposed discounts of 30, 20 and 10 per cent were too low, particularly in comparison to competition investigations involving cartels. One respondent suggested discounts of up to 50 per cent.

Our response

The Authority has decided not to alter the settlement discount percentages. They are consistent with discounts offered by other regulators and they reasonably reflect the benefits of settlement. The discounts for leniency in competition cases are greater than this but cartels are generally considered to be difficult to detect so a stronger incentive is necessary.

It was suggested that settlement discounts should encompass both the mandated parts of a financial penalty and any voluntary payment a company may have made already.

Our response

The Authority recognises the benefits that can arise from settling cases and the need to incentivise companies to settle. However, the Authority believes that consumers who have suffered as a result of the breach should be compensated in full. This means that the Authority will not (except potentially in very exceptional circumstances) reduce any amount identified as detriment and/or gain to be removed from the company and potentially returned as redress to consumers.

Settlement discounts will therefore apply only to the penal element of the penalty (including any recognition in the penal element of sums which are being paid to consumers under voluntary arrangements) and not to any redress payments to customers.

Some respondents asked about the possibility of partial settlements and commented about the procedural aspects of settlement, such as the length of the early settlement window.

Our response

We have already made clear we will not operate a system of partial settlements. Partial settlements would not realise the resource savings we are seeking to achieve through settlement discounts because some issues would still be contested. We addressed this and other procedural points in the Enforcement Guidelines and decision document.

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

Financial viability of companies

One respondent said that penalties should not be set at a level that would "cripple" a business. Another respondent sought more clarity on the circumstances in which the Authority might reduce a penalty in order to ensure that it was reasonable overall.

Our response

The Authority has considered this issue and has decided to clarify in the policy statement that it will consider the financial viability of a company when deciding whether the amount of any proposed financial measure is reasonable in light of its principal objective. This will apply to any redress payments that the Authority might order as well as to any penalty. However, the Authority cannot rule out the possibility that penalties and/or redress payments for the most serious breaches could force a company out of business.

One respondent said we should treat all companies the same way regardless of size.

Our response

The Enforcement Guidelines decision document noted that apparently similar but separate cases are rarely identical and so do not merit identical treatment. Requests that apparently similar breaches should be treated identically do not take proper account of potential variations in the reasons for the breach, the compliance history of the parties concerned, their conduct once the breach became apparent or the amount of harm or potential harm caused by the breach.

Interaction between a penalty and financial redress

One respondent said DECC's Impact Assessment (IA) had assumed that the new redress powers would increase the amount of redress paid to consumers and reduce penalties. The respondent said that our proposed policy statement was not aligned with this, and that it should be.

Our response

DECC's IA states "An expected impact…is that financial losses to consumers would be addressed to a greater extent through redress payments rather than fines". We agree. We think that our proposed policy statement was consistent with this. It made clear that we will encourage or require compensation to be paid to affected consumers (or to proxy groups) as appropriate.

Other things being equal, if the Authority makes a redress order this should reduce any penalty as compared to the period before the Authority could make redress orders. However, the Chairman's letter has already signalled that a greater emphasis on deterrence is likely to increase penalties significantly.

As noted above, we have made clear in the policy statement that penalties will not include a sum recovering the financial benefit that a company derived from a breach if this sum has been or is being adequately distributed to consumers via a redress package. It is, though, an important point of principle that non-compliance should always be more costly than compliance and - consistent with the Chairman's letter - that penalties should act as a significant deterrent to future non-compliance.

Many respondents noted that our policy statement said the Authority "will normally make a consumer redress order". They pointed out that the government's intention was that redress orders should be used only as a last resort. Some respondents said the policy statement should say more about the possibility of voluntary redress packages.

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

Our response

The Authority acknowledges that the government's policy intention as expressed in the IA is clear. It has therefore decided to remove the presumption in the policy statement that it will normally make redress orders. The Authority will, at least initially, not use redress orders as a matter of course, provided that companies voluntarily offer appropriate redress to consumers. However, if it becomes clear that this approach is not proving effective, for whatever reason, the Authority may adjust its approach. This is not precluded by the legislation.

We have clarified that we will consider any redress that has been or is already being provided as part of our calculations on the level of detriment that needs to be removed from the company and that decision-makers may order additional redress if necessary to ensure that the redress as a whole properly reflects the detriment suffered by consumers. We have also added material on the possibility and potential benefits of voluntary redress.

The proposed policy statement said that only if it was "impossible or wholly impracticable" to compensate the consumers that had been directly affected by a breach would the Authority agree that redress should be directed towards other consumers. Several respondents asked whether the Authority would take into account cost considerations when deciding which consumers should receive redress payments.

Our response

The Authority is determined to uphold the principle that redress should be made to the consumers who were directly affected by a breach. The policy statement is clear on this. However, the Authority does recognise that it may not be possible or practicable to do so in every case. For example, the Authority will consider whether or not the administration costs involved would be disproportionate to the benefit of the redress that is required. The policy statement has been amended to reflect this.

One respondent said that any financial measures in a redress order should not go beyond what is necessary to restore the *status quo ante*. The same respondent stated that any deterrent element in a redress order should be non-financial (such as writing letters of apology or changing company procedures) and that any financial measures beyond those necessary to recompense consumers, which are intended to deter further breaches, should be in the penal element.

Our response

The legislation states that under a redress order the Authority may require the company to do (or stop doing) things that it considers necessary to remedy the breach or prevent a contravention of the same or a similar kind. Paragraph 5.3 of the policy statement makes it clear that this could encompass non-financial and financial actions depending on the individual circumstances of the case.

Scope of remedies under a redress order

Some respondents commented on the Authority's policy about making redress payments to proxy groups. They suggested that:

- the proposed proxy should reflect the likely wishes of the consumers affected
- if a proxy closely linked to the nature of the contravention cannot be found, other payments benefitting consumers should be considered before the full payment is made in the form of a penalty

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

- we develop a sliding scale of groups to whom proxy payments could be made
- it might be reasonable, in cases involving non-domestic consumers, to make payments to domestic consumers if no suitable proxy can be found.

Our response

As noted above, the Authority starts from the position that the consumers who were directly affected should be recompensed. If necessary, and in line with paragraph 7.5 of the policy statement, the Authority will consider suitable proxies according to the specific circumstances of each case.

Redress administration costs

We proposed that companies should bear all of the administration costs arising from a redress order. Most respondents did not agree. Some said that the Authority should take administrative costs into account when setting the amount of a penalty.

Our response

The Authority considers that companies ought to bear these costs and that this will maximise the incentive on them to administer redress efficiently. However, we have made clear in the policy statement that the Authority will, in determining the requirements of a redress order, have regard to better regulation principles, including whether the likely administration costs are disproportionate to the expected benefits of the redress.

Some respondents suggested that if several companies commit the same breach in close succession the Authority should ensure that the administrative costs arising from any redress orders are divided fairly.

Our response

Our principal concern is that redress in each case should be targeted as closely as possible to the affected consumer and to the individual circumstances of the case in order for the redress to remedy the result of the specific contravention. With that in mind, the Authority will consider the likely benefits and costs of a proposed redress scheme in the light of the particular circumstances of the case.

New policy statement

We would like to thank all stakeholders for their contribution to the development of our new penalties and redress policy statement. This document is available on our website. Please contact Anna Stacey on 020 7901 7000 or at anna.stacey@ofgem.gov.uk if you have any queries in relation to the issues raised in this letter.

Yours faithfully

Sarah Harrison
Senior Partner, Sustainable Development

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**