

Notice of decision to impose a financial penalty pursuant to section 27A(3) of the Electricity Act 1989

Decision of the Gas and Electricity Markets Authority to impose a financial penalty, following an investigation into compliance by Drax Power Limited with the requirements of Article 14(1) of the Electricity and Gas (Community Energy Savings Programme) Order.

16 March 2015

1. Summary

1.1. The Gas and Electricity Markets Authority ("the Authority") has decided to impose a financial penalty of £5 million on Drax Power Limited (Drax) on the basis that Drax will pay £20 million in consumer redress to National Energy Action ("NEA") and separately has agreed delivery of energy efficiency measures to the value of £3 million¹. The payment to the NEA will be made on 1 April 2015. NEA will use these funds for projects which pursue the following objectives for vulnerable consumers:

- the promotion of energy efficiency in domestic homes;
- the alleviation of fuel poverty;
- the reduction of carbon emissions in domestic homes.

The delivery of the further energy efficiency measures will be completed by October 2016.

1.2. This follows an investigation by Ofgem into Drax's failure to meet its obligations under Article 14(1) of the Electricity and Gas (Carbon Emissions and Community Energy Saving) Order 2009 ("CESP Order"), and consideration by the Authority of representations or objections received on its proposed penalty. These representations or objections are discussed in the Annex to this Penalty Notice.

1.3. Under Article 14(1) of the CESP Order, generators and suppliers had to achieve their carbon emissions reduction obligations by promoting qualifying actions to domestic energy users in low income areas.

1.4. The investigation arose following the submission of the final CESP report to the Secretary of State on 30 April 2013², which provided details of the obligated parties' ("OP") achievements of the targets and obligations

¹ The Authority requires that any consumer redress must not adversely interfere with the delivery of other energy efficiency schemes such as the Energy Company Obligation (ECO), or create an unreasonable administrative burden for Ofgem.

² <https://www.ofgem.gov.uk/ofgem-publications/58763/cesp-final-report-2013final-300413.pdf>

under the CESP, which finished on 31 December 2012.³ The report sets out that Drax did not comply with the targets set out in its CESP obligation.

- 1.5. The Authority noted that Drax had an obligation to promote carbon savings equivalent to 895,138 tonnes ("tCO₂") to be delivered by 31 December 2012. Drax ultimately delivered 37.1% of its carbon target leaving a shortfall of 562,826tCO₂ by 31 December 2012. Drax accepts that it breached Article 14(1) of the CESP Order.
- 1.6. The Authority also noted that Drax took no action to mitigate the shortfall and has had regard to this in setting the level of penalty.
- 1.7. The Authority has decided that Drax breached Article 14(1) of the CESP Order through having failed to achieve its carbon emissions reduction obligation by promoting qualifying actions to domestic energy users by 31 December 2012.
- 1.8. The Authority has decided it appropriate to impose a financial penalty on Drax for the contravention of Article 14(1) of the CESP Order, which occurred on 31 December 2012.
- 1.9. In the circumstances, the Authority has decided to impose a penalty of £5 million on Drax in respect of its failure to comply with Article 14(1) of the CESP Order, on the basis that Drax will also pay £20 million in consumer redress to NEA on 1 April 2015 and separately has agreed delivery of energy efficiency measures to the value of £3 million by 31 October 2016.
- 1.10. In deciding on the level of the penalty, which the Authority considers reasonable in all the circumstances, it took into account the following matters:
 - (a) Drax's failure to achieve the CESP target was a very serious contravention of a major environmental programme;
 - (b) The extent of the shortfall in delivery of carbon reduction measures by Drax was 582,826tCO₂ or 62.9% of its original obligation;
 - (c) Drax has made a significant financial gain from the breach by not incurring costs that it would have incurred if it had complied with its obligation;
 - (d) Drax did not undertake any action to mitigate the shortfall;
 - (e) The level of consumer detriment is high and on-going;

³ Article 8(3) of the CESP Order provided that the obligation period for all generators ended on 31 December 2012.

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- (f) The case involves a significant aggravating factor (which is set out in paragraphs 6.11 to 6.22);
- (g) The case has a mitigating factor (which is set out in paragraphs 6.45 to 6.48); and
- (h) Drax has agreed to settle this investigation.

1.11. In the judgement of the Authority, the aggregate of the penalty and the amount of consumer redress is a higher figure because of the factors set out in paragraphs (a) to (f) above, and a lower figure than would have been the case if Drax had not taken the steps as set out in paragraphs (g) and (h) above. The aggregate of the penalty and of consumer redress is larger than the detriment suffered by consumers and the gain made by Drax.

1.12. The penalty must be paid by 30 April 2015.

2. Background

The Community Energy Saving Programme

- 2.1. The Community Energy Saving Programme ("CESP") was a policy, set down in legislation, designed to improve domestic energy efficiency standards in the most deprived geographical areas across Great Britain. The relevant legislation was the Electricity and Gas (Community Energy Saving Programme) Order 2009 ("CESP Order"). CESP was structured to incentivise energy companies to install particular measures which had hitherto not been the focus of energy efficiency schemes, and to undertake as much activity as possible in each house treated and in each area targeted, via a number of incentives. These incentives included individual measure uplifts to incentivise particular measures such as solid wall insulation; whole house bonuses where more than one energy efficiency measure was installed in a property; and area bonuses when at least 25% of all dwellings in a low income area were treated by the same obligated party ("OP").
- 2.2. Article 14(1) of the CESP Order required that certain gas and electricity suppliers and certain electricity generators had to achieve their carbon emissions reduction obligations by promoting qualifying actions to domestic energy users in areas of low income in Great Britain.
- 2.3. The CESP obligation ran from 1 October 2009 to 31 December 2012 (referred to here as the 'compliance period'). Obligations under the CESP Order (including Article 14(1) referred to above) are relevant requirements for the purposes of the powers of the Authority to impose a

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financial penalty for any failure to comply with such, under sections 27A Electricity Act 1989.⁴

- 2.4. The Department of Energy and Climate Change (“DECC”) was responsible for drafting and implementing the legislation governing the scheme. This included setting the overall CESP target. Ofgem was responsible for administering the CESP, on behalf of the Authority.

Drax’s obligation under CESP

- 2.5. Drax had a total obligation of 895,138tCO₂ which it failed to meet. Drax delivered 37.1% of its carbon emissions reduction target leaving a shortfall of 582,826tCO₂.

The Investigation

- 2.6. Ofgem takes compliance with all obligations seriously. When it became clear to Ofgem that there was a risk of non-compliance with CESP by several parties, Ofgem published an open letter dated 21 September 2012⁵, setting out its approach to enforcement in relation to CESP. This letter set out the way Ofgem and the Authority would approach actions taken by the OPs under CESP after the scheme’s end date of 31 December 2012. The letter stated that Ofgem would take mitigation action into account in its enforcement procedures.⁶
- 2.7. Following the submission of the final CESP report to the Secretary of State on 30 April 2013 (see paragraph 1.4), Ofgem launched an investigation into Drax. In particular, Ofgem investigated whether Drax had met its carbon emissions reduction target set out under the CESP Order.

⁴Please see section 41A(7A)(a) Electricity Act 1989 and Article 27 of the CESP Order.

⁵<https://www.ofgem.gov.uk/ofgem-publications/58765/open-letter-cert-cesp-210912.pdf>

⁶ Ofgem also published three other open letters:

- (i) on **20 December 2012**, setting out the administrative arrangements that Ofgem would use to process the mitigation actions delivered by OPs under CESP;
- (ii) on **31 January 2013**, setting out the way the Authority and Ofgem would approach the assessment and timing of mitigation actions taken by OPs under CESP; and
- (iii) on **29 May 2013**, setting out the administrative arrangements that Ofgem would use to process the mitigation actions delivered beyond 30 April 2013.

3. The Authority's decision on breach

- 3.1. Following an investigation by Ofgem into Drax's compliance with the CESP Order, the Authority is satisfied that Drax breached Article 14(1) of the CESP Order.
- 3.2. Article 14(1) CESP Order is a relevant requirement for the purposes of section 27A Electricity Act 1989 (the Authority's power to impose a financial penalty⁷). Article 14(1) mandated that Drax achieve its carbon emissions reduction obligation by promoting qualifying actions to domestic energy users in low income areas.
- 3.3. Drax failed to meet, by 31 December 2012, its carbon emissions reduction obligation mandated under Article 14(1) of the CESP Order. It delivered 332,312tCO₂ and had a shortfall of 562,826tCO₂ against its overall target of 895,138tCO₂.
- 3.4. This failure is evidenced by the Authority's report to the Secretary of State in April 2013 in which the Authority set out the levels of carbon emissions reductions achieved by OPs and whether they had met their obligations. Drax does not dispute that the breach occurred.
- 3.5. In light of the finding of breach, the Authority considered whether to impose a financial penalty, under section 27A of the Electricity Act 1989.

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 considered whether a financial penalty is appropriate in accordance with the requirements of the Electricity Act 1989 and having regard to its published Statement of Policy with respect to Financial Penalties (October 2003) ("the Penalties Policy")⁸.
- 4.2. The Authority is required to take a decision on penalty in the manner which it considers is best calculated to further its principal objective⁹, and having regard to its other duties.

⁷ See footnote 5

⁸ <https://www.ofgem.gov.uk/ofgem-publications/74207/utilities-act-statement-policy-respect-financial-penalties.pdf>

⁹ The Electricity Act 1989 (section 3A) sets out details of the Authority's principle objective for energy regulation, the protection of the interests of present and future consumers, wherever appropriate by promoting competition, to include their interests in the reduction of greenhouse gas emissions and the ensuring of the security of energy supply.

- 4.3. In deciding that it would be appropriate to impose a penalty, the Authority considered and took into full account the particular facts and circumstances of the contravention under consideration, including the extent to which the circumstances from which the contravention or failure arose were outside the control of Drax. It also took full account of the representations made to it by Drax.

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. The Authority considered that Drax's breach of Article 14(1) of the CESP Order damaged the interests of consumers in that energy efficiency measures were not installed in people's homes by the end of the CESP compliance period. A significant number of energy consumers have therefore been unable to benefit from CESP energy efficiency measures which they ought to have received. This means that such consumers face higher energy bills than would otherwise be the case. This has had a material impact on consumers who have been without these measures for at least twenty months and for whom the impact is ongoing due to Drax's failure to take any steps to install the measures.
- 4.5. Had Drax met its target, it is estimated that around 3,770 households would have benefited from energy efficiency measures under CESP. These households were also more likely to have been living on a low income than the average household in Great Britain, because CESP was targeted at low income areas.
- 4.6. Further, the Authority considered whether non-compliance damaged the interests of other market participants who complied with CESP. The Authority considered the evidence to be inconclusive but notes that the case does not turn on this point.

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

- 4.7. The Authority considered that imposing a financial penalty is likely to create an incentive to compliance and deter future breaches:
- (a) both generally, as the Authority considered compliance with mandatory deadlines to be very important and not imposing a

penalty in this case would not create the right incentives around the need for regulated parties to comply with deadlines; and

- (b) specifically, in relation to environmental programmes, to incentivise companies to comply in full and on time with future mandatory energy efficiency obligations such as the Energy Companies Obligations ("ECO").

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

If the contravention is trivial in nature

- 4.8. The Authority did not consider that Drax's failure to meet its CESP obligation was trivial. The Authority notes that Drax's shortfall was 562,826tCO₂, which was equivalent of installing energy efficiency measures in around 3,770 households.

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

- 4.9. The Authority did not consider that its principal objective and duties, as set out in section 3A Electricity Act 1989, preclude the imposition of a financial penalty in this case.
- 4.10. In reaching this conclusion, the Authority had regard to, amongst other factors, Drax's ability to finance its generation activities referred to in section 3A(2)(b) Electricity Act 1989 and the need to contribute to the achievement of sustainable development referred to in section 3A(2)(c) Electricity Act 1989.
- 4.11. In failing to comply with the mandatory targets of the CESP Order, the Authority considered that Drax failed to contribute to the achievement of sustainable development in the manner expected, and required, of it.

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

- 4.12. The Authority considered that the breach or possibility of a breach would have been apparent to a diligent licensee. OPs were given over three years to deliver their full obligation and were aware that a breach of this obligation would occur if they did not meet their full obligation by 31 December 2012.

Conclusion

4.13. Having taken into account the factors set out in the Penalties Policy and the representations made by the company, the Authority decided that the imposition of a penalty was appropriate in this case.

5. Criteria relevant to the level of financial penalty

5.1. In accordance with section 270 of the Electricity Act 1989, the Authority may impose a financial penalty of up to 10% of the annual turnover of the relevant license holder. The Authority was satisfied that penalty fell within the maximum statutory limit.

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 Penalties Policy.

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

The seriousness of the contravention and failure

5.3. The Authority considered that Drax's breach of CESP was extremely serious. OPs had over three years to comply with the CESP obligation. Four of the ten parties with obligations under CESP complied. The Authority expects regulated parties to meet mandatory obligations, in full and on time.

5.4. Drax incurred a shortfall of 562,826tCO₂ (see paragraph 1.5 above). That shortfall is detrimental to the social policy objectives underlying the CESP obligation, which were to ensure consumers in low income areas in Great Britain benefit from multiple measures to make their homes more energy efficient, reducing their energy bills and increasing thermal comfort. The Authority also noted that unmitigated shortfalls are detrimental to the United Kingdom's commitment under the Climate Change Act 2008 to reduce carbon emissions by 80% by 2050 compared to 1990 levels.

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

- 5.5. The degree of consumer harm has been set out above (see paragraphs 5.4 to 5.6). Consumer harm is ongoing due to Drax's failure to take any action to mitigate the shortfall.

The duration of the contravention or failure

- 5.6. The breach of the obligation occurred at the deadline on 31 December 2012 when Drax did not comply with the targets set out in its CESP obligation. After this date, the breach did not continue, although the effects of the contravention are ongoing.

The gain (financial or otherwise) made by the licensee

- 5.7. The Authority considered whether or not Drax may have made a financial gain through not meeting its CESP obligation by the statutory deadline or at all.
- 5.8. The Authority considered that Drax did make a significant financial gain through avoiding costs. In the period January 2013 to October 2014, Drax has avoided costs through non-delivery of its unmitigated shortfall of 562,826tCO₂. The Authority also considered that, on a time value of money basis, Drax had made a gain by being able to put its non-expenditure to alternative use in its organisation. The Authority considered that both gain due to non-expenditure and the value to Drax of retaining that investment for the months to October 2014 should be taken into account when setting the level of penalty.

Factors tending to increase the level of penalty

Repeated contravention or failure

- 5.9. Drax had not previously failed to meet an energy efficiency obligation. The Authority did not consider that this aggravating factor applied.

Continuation of contravention or failure after either becoming aware of the contravention or failure or becoming aware of the start of Ofgem's investigation

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5.10. The breach of the obligation was “one off” and occurred at 31 December 2012 although the effects of the breach are ongoing. The Authority did not consider that this aggravating factor applied.

The involvement of senior management in any contravention or failure

5.11. Drax appointed a contractor to deliver its full carbon emissions reduction obligation. Drax provided information to show that throughout the compliance period, its CESP delivery was regularly raised with senior management at Executive Committee meetings, and featured in CEO reports. Minutes from the Executive Committee show that CESP was discussed at many of its meetings.

5.12. From reviewing the evidence, the Authority considered that Drax’s senior management had early knowledge of Drax’s slow progress in CESP delivery. It became apparent to senior management from July 2011 that Drax was unlikely to be able to comply with its obligation. Evidence shows that senior management discussed how to approach its potential non-compliance and argue against any decision by Ofgem to impose a penalty as early as October 2011.

5.13. Drax continued to put pressure on the contractor and also made attempts to engage with Ofgem and DECC to find alternative ways of meeting their obligation. In September 2012, Drax accepted that the contractor would not deliver its obligation and management decided to enter into agreements with other OPs and service providers to purchase carbon or to deliver further CESP measures. Drax management made the decision to spend the remainder of what had been budgeted for the contract. Drax has explained in detail the reasons for not spending any more:

- (a) The price of CESP carbon on the market had been driven up by its scarcity and bidding on what remained would have driven the price up even further;
- (b) By late 2012, the compliance period was almost at an end and it was not possible to embark on any new CESP schemes that could deliver before the deadline;
- (c) Drax considered that an approach of being prepared to spend more would not produce any net advantage for the environment or for low income consumers. Drax said this was because the only available compliance measures were by way of transfer at a premium from suppliers which had already delivered the measures offered for transfer and passed the costs through to consumers;

- (d) The result of spending more would be an even greater competition distorting transfer of resources from an independent generator to vertically integrated companies which had surplus carbon to sell;
 - (e) In late 2012, Drax was engaged in arranging financing to fund a project to convert three of its six generating units to biomass. In particular, Drax undertook an equity placing in October 2012. Spending the amount that would have been required to meet its obligation at that point would have required them to issue a profits warning which could have jeopardised the funding arrangements.
- 5.14. Drax have put to us that the biomass conversion was projected to save 10 million tonnes of carbon emissions per year whereas their CESP obligation was to achieve just under 900,000 tonnes over the lifetime of the measures. The Authority noted that CESP was expected by DECC to make an important contribution towards meeting the United Kingdom's obligations in relation to the reduction of greenhouse gases and delivery of renewable power.
- 5.15. Drax considered that its Board faced two competing legal obligations – that to meet its CESP obligation, thereby spending beyond the allocated £16.6 million, and that the directors' duty under the Companies Act 2006 to act in the way most likely to promote the success of the company as regards the decisions on spending and the impact CESP decisions could have on the biomass project. The Authority considered that the the best interests of stakeholders must include compliance with mandatory legal obligations, such as CESP.
- 5.16. The Authority considered the following were key factors involving senior management which contributed to Drax's non-achievement of its obligation:
- (a) A failure to respond to market prices;
 - (b) The decision to continue to rely on the contractor to deliver despite it becoming increasingly obvious that it would not deliver Drax's obligation;
 - (c) A failure to consider putting in place a contingency plan or to increase its CESP budget;
 - (d) The decision to limit its spending to the amount which had been agreed with the contractor.
- 5.17. Drax entered into a fixed-price contract with a third party provider to deliver carbon reduction measures to meet its obligation and to provide

additional expertise. Evidence shows that Drax continued to rely upon the contractor and to put pressure on them to deliver. Although this was its contractual right, it was Drax's obligation to deliver the CESP measures; the Authority considers that Drax should have put in place a contingency plan for delivering its CESP obligation as soon as the risk of the contractor's non-delivery became apparent. It should also have considered increasing its budget in line with the price of carbon, particularly as there was carbon available on the market which Drax did not buy and which remained unsold.

- 5.18. Drax provided representations for why it had not sought other methods of delivery based on its contractual and legal obligations. Drax submits that its senior management had to act responsibly within a commercial manner and could not simply commit unlimited funds to ensure compliance. The Authority agrees that companies should seek to manage their contracts and costs effectively. However, the Authority considered that sufficient priority must be given to complying with legal obligations.
- 5.19. Drax also provided representations on the impact that spending more could have had on its biomass conversion project which would deliver significant carbon savings. The Authority considered that if Drax had reacted more promptly, it would have been better placed to meet its obligations than it was in late 2012. Whilst that Authority recognised the benefits of the biomass conversion project and the impact that further spending may have had on funding arrangements, it considered that Drax essentially made a business decision to proceed with the biomass project with the effect that its legal obligations under the CESP were not given sufficient priority.
- 5.20. Even given the particular circumstances of Drax's biomass conversion project in late 2012, the Authority considered that Drax had sufficient financial resources prior to the share placement to meet the CESP obligation. The Authority accepted that it is a decision for the Board of Drax as to how to deploy its resources; however this should have included giving sufficient weight to Drax's legal obligations. The Authority also noted that Drax could have deployed resources to take action after its successful fundraising. It failed to do so.
- 5.21. Given the oversight of CESP provided by Drax's senior management and the matters described above, the Authority considered that Drax's senior management could and should have taken more action to prevent Drax's failure to meet its CESP target. Furthermore, the fact that Drax's senior management took the decision to limit their spending on CESP, albeit they

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considered that they had conflicting statutory duties, was a significant factor in the contravention.

5.22. For the reasons set out above, the Authority therefore considered that this aggravating factor applies to a significant extent.

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

5.23. Drax has provided evidence to show that it had internal procedures/mechanisms in place to prevent contravention of CESP.

5.24. Until August 2012, Drax received quarterly reports from the contractor showing the progress of compliance with the obligation. Thereafter, they relied upon the monthly reports submitted directly to Ofgem by the contractor. No notes of telephone calls have been provided by Drax to Ofgem, though Drax state that they informed the content of the quarterly reports made to its Executive Committee.

5.25. CESP featured on Drax's risk register with an assessment of risk as 'low' until September 2012 when this was changed to 'high'; this happened when Carillion confirmed it would not meet its contractual obligation.

5.26. Taking the above into account, the Authority did not consider that there was an absence of any evidence of internal mechanisms or procedures intended to prevent contravention or failure. Accordingly, this aggravating factor does not apply.

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

5.27. The investigation found no evidence of any attempt to conceal the contravention from Ofgem. The Authority did not consider that this aggravating factor applies.

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

5.28. The Authority expected a licensee seeking to meet its CESP obligation to devise a plan capable of achieving delivery within the compliance period –

i.e. before 31 December 2012. This delivery process should have been subjected to appropriate management supervision.

- 5.29. At the beginning of the CESP compliance period, Drax made the strategic decision to achieve compliance through contracting a third party to deliver its carbon reduction emissions obligation under CESP. A competitive tendering exercise resulted in the appointment by Drax of a contractor to deliver its full carbon emissions reduction obligation. The contractor delivered only 11% of Drax's obligation by December 2012.
- 5.30. Drax has attributed its contravention to under-performance by the contractor and its lack of experience with this type of obligation. It has referred to a number of steps it took to manage the contract.
- 5.31. Whilst Drax put in place a contract for delivery for its obligation and did have some oversight of performance, the Authority is of the view that the risk of non-delivery by the contractor would have been reduced with a more proactive approach to project management and supervision. Further, it appears to the Authority that at the point things started to go wrong with delivery Drax should have acted more quickly to put a credible "Plan B" in place. However, when it became apparent to Drax that non-compliance was a serious possibility it focussed on seeking changes to its obligation rather than putting in place a credible alternative plan to deliver its obligation on time.
- 5.32. OPs with downstream retail businesses, in contrast to independent generators such as Drax, had previous experience of schemes such as Energy Efficiency Commitment (EEC) and also had existing access to contacts such as local authorities and housing associations and a database of domestic customers. The Authority considered this lack of previous experience is relevant at the onset of the scheme to Drax's ability to devise a "Plan B" when things started to go wrong.
- 5.33. Drax did take some action to secure compliance including:
- (a) In November 2012, Drax entered into agreements with two other OPs to transfer surplus qualifying actions.
 - (b) In October/November 2012, it entered into two schemes with third parties to deliver additional CESP schemes.
- 5.34. However, this action was very late in the day and not capable of securing compliance by 31 December 2012. Furthermore, there was additional carbon available on the market which Drax chose not to buy because of its

limited budget. For these reasons, the Authority was of the view that this mitigating factor does not apply.

Appropriate action by the licensee to remedy the contravention or failure

- 5.35. As noted in Ofgem's Open Letter of September 2012, mitigation action would not be a substitute for compliance with the carbon emission reduction obligations and OPs should not be able to benefit from non-compliance. However in considering mitigation actions, Ofgem said that "we will give most weight to CERT/CESP measures that are delivered shortly after 31 December 2012". Ofgem later stated in its January 2013 Open Letter that 30 April 2013 would be a key date for assessing the mitigation actions taken by parties.
- 5.36. Drax stated that it took steps to engage with Ofgem and DECC to discuss alternative ways of discharging its obligation and to attempt to discuss what Ofgem would accept as mitigation. Drax considered that there was a lack of clarity about mitigation as described in the letter of September 2012. The Authority was of the view that it was for the OPs to decide how to approach compliance and mitigation and what further action to take. It would not have been appropriate, at that stage, for Ofgem to agree to any specific plans given the compliance period still had several months to run and Ofgem's objectives were to encourage compliance and, failing that, mitigation in 2013 as per the Open Letter.
- 5.37. The Authority noted that Drax took no action to mitigate its carbon shortfall. In light of this, the Authority considered that Drax did not take appropriate action to mitigate the breach and that this mitigating factor does not apply in this case.

Evidence that the contravention or failure was genuinely accidental or inadvertent

- 5.38. Drax has made representations that certain factors affected its ability to deliver the CESP obligation by 31 December 2012. These include the design of the obligation, specifically an issue with passing costs through to customers in comparison to vertically-integrated suppliers, CESP being an inappropriate obligation to be imposed on independent generators, its being let down by its contractor and that the CESP did not match assumptions in DECC's impact assessment affected their ability to deliver the obligation by the due date. These factors have been considered in paragraphs 6.45-6.48 and 6.31.

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5.39. The Authority did not consider that these representations suggest that the contravention was genuinely accidental or inadvertent. Given that the OPs had over three years to secure compliance with the CESP scheme and it has seen no evidence to suggest that Drax's contravention was genuinely accidental or inadvertent.

5.40. Accordingly, the Authority did not consider that this mitigating factor applies.

Reporting the contravention or failure to Ofgem

5.41. The arrangements under the CESP Order were that the Authority was required to report in April 2013, to the Secretary of State for Energy and Climate Change, its determination as to OPs had achieved their carbon emissions reduction targets or not. This report was duly presented and the OPs were notified of its conclusions. The Authority therefore considered that this factor does not apply.

Co-operation with Ofgem's investigation

5.42. Drax has responded to Ofgem's Information Requests on time and complied with Ofgem's investigations process. However, the Authority considered that this mitigating factor should only apply where co-operation has gone beyond what would be expected of any licensee facing enforcement action¹⁰.

5.43. In this case, Drax has accepted that it was in breach and agreed to settle the case at the earliest opportunity. This has achieved a speedier resolution and avoided additional spending of resource by the regulator. Accordingly, the Authority did consider that this mitigating factor applies and the Authority has imposed a lower penalty than it would otherwise have imposed.

Other factors

5.44. It was the view of the Authority that the following additional factor tends to reduce the level of any penalty is relevant in this matter.

¹⁰ See the Notice of decision to impose a financial penalty upon SSE for non-compliance with its obligations under conditions 23 and 25 of the Standard Conditions of the Electricity and Gas Supply Licences - <https://www.ofgem.gov.uk/sites/default/files/sse-penalty-notice.pdf>

Design and administration of CESP scheme and the ability of Drax to deliver it.

- 5.45. The Authority considered the extent to which the design and administration of CESP may have adversely affected Drax's ability to deliver CESP by 31st December 2012 and the extent to which Drax was disadvantaged compared to suppliers through lack of experience with this type of obligation; for example, a lack of domestic retail customer base. The Authority considered the evidence including a report commissioned by DECC, Evaluation of the Carbon Emissions Reduction Target and Community Energy Saving Programme¹¹.
- 5.46. The Authority considered that CESP was a complex programme. The complexity stemmed from the design of CESP which promoted new approaches and innovation. These factors led to technical and management challenges for all OPs, and for Ofgem, in administering the CESP. Further, the Authority noted there were a number of issues which impacted upon scheme approval times. These include: the scheme's promotion of new approaches and innovation leading to many technical issues which had to be resolved during the scheme, the complexity of the programme and legislative requirements, initial predictions (which determined resourcing) regarding scheme numbers proving inaccurate, and a slow start to CESP by OPs resulting in back-loading of activity later into the programme.
- 5.47. The Authority considered that these factors were not insurmountable as several OPs secured compliance. Further, in the case of Drax the Authority did not consider that these factors prevented the company from complying with its obligations. Nonetheless, the Authority considered it reasonable in all of the circumstances that this is a small mitigating factor in this case.
- 5.48. The Authority considered that the lack of previous experience is relevant to Drax's ability to meet its obligation and therefore considered that a mitigating factor applies to an extent. However, the Authority also considered that as a large company, Drax was sufficiently well placed to put in place robust contract monitoring arrangements if it decided the use of a contractor was the best way to meet its obligations and to overcome its lack of experience. The Authority considered that this mitigating factor only partially applies.

6. The Authority's proposed decision as to the level of penalty

¹¹ <https://www.gov.uk/government/publications/evaluation-of-the-carbon-emissions-reduction-target-and-community-energy-saving-programme>

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- 6.1. Taking all of the above into account, which includes the representations or objections submitted in response to its proposed penalty, the Authority has decided to impose a financial penalty of £5 million on Drax on the basis that Drax will also pay £20 million to NEA on 1 April 2015 and separately has agreed delivery of energy efficiency measures to the value of £3 million by 31 October 2016.
- 6.2. The Authority considered this penalty to be reasonable in all the circumstances of the case. In reaching this decision the Authority has taken into account the following:
- (a) Drax's failure to achieve the CESP target was a very serious contravention of a major environmental programme;
 - (b) The extent of the shortfall in delivery of carbon reduction measures by Drax was 582,826tCO₂ or 62.9% of its original obligation;
 - (c) Drax has made a significant financial gain from the breach by not incurring costs that it would have incurred if it had complied with its obligation;
 - (d) Drax did not undertake any action to mitigate the shortfall;
 - (e) The level of consumer detriment is high and on-going;
 - (f) The case involves a significant aggravating factor (which is set out in paragraphs 6.11 to 6.22);
 - (g) The case involves some mitigating factors (as set out in paragraphs 6.44 to 6.48); and
 - (h) Drax has agreed to settle this investigation.

In the judgement of the Authority, the aggregate of the penalty and the amount of consumer redress is a higher figure because of the factors set out in paragraphs (a) to (f) above, and a lower figure than would have been the case if Drax had not taken the steps as set out in paragraphs (g) and (h) above. The aggregate of the penalty and of consumer redress is larger than the detriment suffered by consumers and the gain made by Drax.

6.2 The penalty must be paid by 30 April 2015.

Gas and Electricity Markets Authority

16 March 2015

Annex:

Representations or Objections on the Proposed Penalty

Introduction

1.1 The Authority received 10 representations or objections in response to its proposed penalty. The points made by the respondents can be grouped into four areas:

- The level of proposed penalty was too low (see paragraphs 1.2 to 1.5)
- The proposed Penalty Notice lacked transparency (see paragraphs 1.6 to 1.8)
- Points in relation to consumer redress (see paragraphs 1.9 to 1.14)
- Other matters (see paragraphs 1.15 to 1.19)

1.1 The Authority has considered carefully all of the representations or objections, and its responses in respect of these four areas are set out below.

The level of proposed penalty was too low

1.2 Five respondents submitted that the level of proposed penalty was too low. They contended that, in assessing the extent to which Drax may have made a financial gain, the Authority should have compared Drax's expenditure on CESP with the market rates for CESP measures prevailing in the second half of 2012. A number of respondents noted the particularly high market rates (when compared over the whole of CESP) at the end of 2012 referring the Authority to DECC's evaluation report. One respondent questioned whether the level of penalty sent a clear enough signal to all parties about the importance of complying on time and in full for future obligations. Some respondents questioned the statement in the proposed penalty notice that, *"the aggregate of the proposed penalty and the proposed amount of consumer redress is larger than the detriment suffered by consumers and the gain made by Drax."*

1.3 Ultimately, the assessment of financial gain is by necessity a judgment taking into account a number of factors. In coming to its view that Drax made a significant financial gain (see paragraphs 6.7-6.12) the Authority is satisfied that the level of penalty is reasonable in all the circumstances of the case and addresses the seriousness of the contravention.

The proposed penalty notice lacked transparency

1.4 A number of respondents submitted that the proposed penalty notice needed a greater level of detail¹² in order to enable respondents to

comment meaningfully on the level of penalty and/or consider whether Drax gained an unfair advantage from not complying.

- 1.5 The decision on financial penalty (and the prior proposed decision on financial penalty) has been taken by the Authority having regard to its Penalties Policy. This includes that the assessment of the appropriate level of penalty should be taken having regard to a number of factors (rather than as an arithmetical calculation). The Authority is satisfied that the level of detail in this Penalty Notice (and that previously in the proposed Penalty Notice) is fair, consistent with the Penalties Policy and follows the statutory requirements¹³, namely that the Authority states in its Notice:
- (a) that it proposes to impose/has imposed a penalty and the amount;
 - (ii) the relevant condition breached;
 - (iii) the acts or omissions which in the Authority's opinion constitute the contravention or failure and the other facts which justify the imposition of a penalty and the amount proposed for such penalty; and
 - (iv) the time period within which representations or objections may be made with respect to the proposed penalty/the penalty is required to be paid.
- 1.6 Further, the Authority believes that the level of detail in the proposed penalty notice was sufficient for external stakeholders to comment meaningfully.

Points in relation to consumer redress

- 1.7 A number of respondents made a number of points in relation to the consumer redress Drax is proposing. These points are considered below.
- 1.8 As a preliminary matter, the Authority's role is to consider whether the penalty is reasonable in all the circumstances, which includes taking into account any consumer redress paid or to be paid. In this case, the Authority is satisfied that the aggregate of the penalty and consumer redress is reasonable.
- 1.9 One respondent said that redress should be "hard" energy efficiency measures (that is, solid wall insulation and other energy efficiency measures as opposed to more general advice and support). Wherever possible the Authority will wish to see consumer redress aligned to the original harm. Accordingly, the Authority has required that any consumer redress meets one or more of the following objectives: the promotion of energy efficiency in domestic homes; the alleviation of fuel poverty; the reduction of carbon emissions in domestic homes. This is consistent with the policy objectives of CESP. At the same time, the Authority requires that any consumer redress must not adversely interfere with the delivery of other energy efficiency schemes such as the Energy Companies

¹³ In section 27A Electricity Act 1989.

Obligation (ECO), or create an unreasonable administrative burden for Ofgem.

- 1.10 Several respondents submitted representations requesting that they should receive redress monies. The Authority considered that it was for Drax to choose its redress recipients subject to the funding meeting the objectives of CESP (referred to in paragraph 1.9).
- 1.11 The Authority is satisfied that Drax's proposal is within the scope of this mandate. The Authority notes that the consumer redress proposals include a significant amount of "hard" energy efficiency measures, with appropriate safeguards to minimise the risk of interference with ECO.
- 1.12 One respondent said that it would be concerned if the specific details of Drax's redress proposal were not consulted upon. Another respondent questioned whether it would be more appropriate to see redress spread across several organisations rather than just National Energy Action ("NEA").
- 1.13 Paragraph 2.10 above sets out the formal requirements governing a Notice seeking representations on a proposed penalty. It is not in the Authority's view necessary to seek representations or objections on the specific detail of any consumer redress proposals. However, the Authority notes that considerable due diligence has been conducted by Ofgem around the NEA redress proposal to ensure it is as effective as possible. In relation to the representation that it would be more appropriate to see redress spread across several organisations, the Authority accepts that there are advantages with seeing a broad base of recipient organisations. However, this needs to be balanced against the disadvantages of more administratively complex (and potentially expensive) consumer redress arrangements. NEA will be seeking bids for funds to support a wide range of local initiatives and organisations across Great Britain and there will be scope to partner with NEA on projects. This will result in the redress being spread across several organisations. The Authority notes that the NEA is a well-regarded organisation, with a proven track record and national reach, and is satisfied that the NEA is a suitable charitable recipient. Further, the Authority notes that a number of governance and other safeguards will be put in place to protect consumers' interests as part of the redress package.

Other miscellaneous matters

- 1.14 One of the respondents to the proposed penalty notice commented that it had been in discussions about delivering schemes for Drax during the compliance and mitigation periods. They said this would have enabled Drax to improve its compliance and mitigate its under-delivery. The respondent disputed Drax's representation of market conditions as laid out in paragraph 6.13.

- 1.15 The Authority has taken these representations into account. The section which the respondent commented on outlined some of the reasons given by Drax for not spending more on CESP. The section commented on does not represent the Authority's view of market conditions at the relevant time.
- 1.16 The Authority was aware that there was carbon available on the market in 2012 and that Drax chose not to purchase it: see paragraph 6.17 and 6.34. This assessment was one of the factors that led to the Authority concluding that the aggravating factor of the involvement of senior management applied to a significant extent: see paragraph 6.22. Therefore, the points set out in the submission, although providing more detail on energy efficiency measures potentially available, do not change the Authority's assessment of this aggravating factor and what is an appropriate level of penalty.
- 1.17 One respondent raised the following additional points:
- (a) It objected to the Authority's conclusion that a mitigating factor should apply for the design and administration of CESP. It noted that the design of the scheme was equally complex for all OPs, and that costs were incurred by the compliant OPs because of this. The respondent considered the inclusion of this mitigating factor was "unduly lenient" towards the non-compliant OPs, and asked what effect this factor had on the final penalty levels;
 - (b) It commented that with regard to the failure of non-compliant OPs to purchase excess carbon in auctions at the end of the CESP compliance period, the extent to which this was factored into the penalty amounts of those OPs was unclear;
 - (c) It stated that any redress proposals should not distort the ECO and/or Green Deal in such a way that would cause detriment to the compliant CERT and CESP OPs.
- 1.18 Each of these points is taken in turn below:
- (a) Regarding the mitigating factor concerning the design and administration of CESP; the Authority considered this to be appropriate because whilst it noted that all of the compliant OPs were able to overcome these challenges, the fact still remained that CESP was a complex scheme. This was well documented by DECC's evaluation report, and also supported by evidence gathered during the investigation process. Therefore, the particular challenges that were posed by the design and administration of the CESP were relevant facts for the purposes of determining the level of penalty. However, the Authority wishes to clarify that this was a small mitigating factor in its determination of the level of penalty and further, in the Authority's judgement the overall level of financial penalty is such that it would have been better for Drax to have met its obligations on time.

- (b) Regarding the auctions of surplus carbon, this factor was one amongst a number of factors which led to the Authority's decision in each case on whether the aggravating factor relating to the involvement of senior management applied or not (see paragraph 6.17).

- (c) Regarding redress activities causing possible impacts on the ECO and Green Deal programmes, the Authority considers that the proposed redress activities are not on a scale that would cause any significant distortions to these markets.