

## **Notice of Decision to impose a financial penalty pursuant to section 27A(5) of the Electricity Act 1989**

### **Decision of the Gas and Electricity Markets Authority to impose a financial penalty, following an investigation into compliance by British Gas with the requirements of Article 14(1) of the Electricity and Gas (Community Energy Saving Programme) Order 2009**

**5 March 2015**

#### **1 Summary**

- 1.1 The Gas and Electricity Markets Authority (“the Authority”) has decided to impose a financial penalty of £1 on British Gas<sup>1</sup>, on the basis that British Gas has made a payment of £10.6 million (less the £1 financial penalty) in consumer redress to the British Gas Energy Trust (“BGET”). The BGET shall distribute the redress monies to organisations which pursue any or all of the following objectives<sup>2</sup> for vulnerable customers:
- the promotion of energy efficiency in domestic homes;
  - the alleviation of fuel poverty;
  - the reduction of carbon emissions in domestic homes.
- 1.2 This follows an investigation by Ofgem into British Gas’ 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 obligation 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 2013<sup>3</sup>, which provided details of obligated parties’ (“OP”) achievements of the targets and obligations under CESP, which finished on 31 December 2012.<sup>4</sup> The report sets out that British Gas did not comply with the targets set out in its CESP obligation.
- 1.5 The Authority noted that British Gas initially had an obligation to promote carbon savings equivalent to 3,695.259 kilo tonnes (“ktCO<sub>2</sub>”). As was

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<sup>1</sup> The CESP Order placed obligations on individual British Gas licensees. References in this Penalty Notice to British Gas shall be references to British Gas Trading Limited (Electricity).

<sup>2</sup> The Authority requires that any consumer redress must not adversely interfere with the delivery of other energy efficiency schemes such as the Energy Companies Obligation (ECO), or create an unreasonable administrative burden for Ofgem.

<sup>3</sup> <https://www.ofgem.gov.uk/ofgem-publications/58763/cesp-final-report-2013final-300413.pdf>

<sup>4</sup> Article 10(3) of the CESP Order provided that the obligation period for all suppliers ended on 31 December 2012.

permitted under Article 21 of the CESP Order, in 2010 British Gas took on additional obligations from other OPs of 1,971.831 ktCO<sub>2</sub>, which resulted in British Gas having an increased obligation of 5,667.090 ktCO<sub>2</sub> to deliver by 31 December 2012. Therefore, the finding of breach of the CESP Order relates to this increased obligation of 5,667.090 ktCO<sub>2</sub>. British Gas ultimately delivered 62.4% of its increased obligation leaving a shortfall of 2,129.700 ktCO<sub>2</sub> at 31 December 2012. British Gas accepts that it breached Article 14(1) of the CESP Order.

- 1.6 The Authority also noted that British Gas undertook mitigation action equivalent to the volume of its shortfall associated with not achieving the carbon reduction target by August 2013 and had regard to this in setting the level of penalty.
- 1.7 The Authority has decided that British Gas breached Article 14(1) of the CESP Order through having failed to achieve its carbon emissions reduction obligations 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 British Gas 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 £1 on British Gas in respect of its failure to comply with Article 14(1) of the CESP Order, on the basis that British Gas has made a payment of £10.6 million (less the £1 financial penalty) in consumer redress to BGET on 27 February 2015. In deciding on the level of the penalty, which the Authority considers reasonable in all the circumstances, it took into account the following:
  - (a) British Gas's failure to achieve the CESP target was a very serious contravention of a major environmental programme;
  - (b) The extent of the initial shortfall in delivery of carbon reduction measures by British Gas was 2,129.700 ktCO<sub>2</sub> or 37.6% of its obligation;
  - (c) British Gas has made a significant financial gain from the breach and would have needed to have incurred higher costs to deliver all obligated measures by the end of the period;
  - (d) British Gas undertook mitigation action equivalent to the volume of the shortfall associated with its breach albeit this mitigation was not fully complete until August 2013 (after 30 April 2013 which Ofgem said would be a key date for assessing mitigation action);
  - (e) British Gas has one aggravating factor (see paragraphs 5.14-5.20);
  - (f) British Gas has several mitigating factors that apply (see paragraphs 5.29-5.30, 5.33, 5.35-5.37 and 5.38-5.40), and one mitigating factor that partially applies (see paragraphs 5.24-5.28);
  - (g) British Gas has agreed to settle this investigation; and
  - (h) British Gas has made a payment of £10.6 million (less the £1 financial penalty) in consumer redress as set out in paragraph 1.1.

In the judgement of the Authority the aggregate of the penalty and the amount of consumer redress is a lower figure than would have been the case if British Gas had not taken the steps as set out in paragraphs (d) and (g) above, and the aggregate of the penalty and the amount of consumer redress is larger than the detriment suffered by consumers and the gain made by British Gas.

1.10 The penalty must be paid by 17 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").
- 2.2 CESP was structured to incentivise the 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).
- 2.3 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.
- 2.4 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 financial penalty for any failure to comply with such, under sections 27A Electricity Act 1989<sup>5</sup>.
- 2.5 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.

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<sup>5</sup> Please see section 41A(7A)(a) Electricity Act 1989 and Article 27 of the CESP Order.

## British Gas's obligation under CESP

- 2.6 British Gas had an obligation of 5,667.090 ktCO<sub>2</sub>. By 31 December 2012, British Gas had achieved only 3,537.390 ktCO<sub>2</sub> of its obligation and was left with a shortfall of 2,129.700 ktCO<sub>2</sub>.

## The Investigation

- 2.7 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 2012<sup>6</sup>, 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.<sup>7</sup>
- 2.8 Following the submission of the final CESP report to the Secretary of State on 30 April 2013 (see paragraph 1.3 above), Ofgem launched an investigation into British Gas. In particular, Ofgem investigated whether British Gas had met its carbon emissions reduction target set out under the CESP Order.

## **3 The Authority's decision on breach**

- 3.1 Following an investigation by Ofgem into British Gas's compliance with the CESP Order, the Authority is satisfied that British Gas 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 of the Electricity Act 1989 (the Authority's power to impose a financial penalty)<sup>8</sup>. Article 14(1) mandated that British Gas achieve its carbon emissions reduction obligations by promoting qualifying actions to domestic energy users in low income areas.
- 3.3 British Gas failed to achieve, by 31 December 2012, its carbon emissions reduction obligation mandated under Article 14(1) of the CESP Order. It

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<sup>6</sup> <https://www.ofgem.gov.uk/ofgem-publications/58765/open-letter-cert-cesp-210912.pdf>

<sup>7</sup> 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.

<sup>8</sup> Please see footnote 5

delivered 3,537.390 ktCO<sub>2</sub> and had a shortfall of 2,129.700 ktCO<sub>2</sub> against its overall target of 5,667.090 ktCO<sub>2</sub>. British Gas's shortfall in absolute terms was greater than that of any other OP under CESP.

- 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. British Gas 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").<sup>9</sup>
- 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 objective<sup>10</sup>, and having regard to its other duties.
- 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 British Gas. It also took full account of the representations made to it by British Gas.

##### ***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 British Gas's breach of Article 14(1) of the CESP Order damaged the interests of consumers in that energy efficiency

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<sup>9</sup> <https://www.ofgem.gov.uk/ofgem-publications/74207/utilities-act-statement-policy-respect-financial-penalties.pdf>

<sup>10</sup> The Electricity Act 1989 (section 3A) sets out details of the Authority's principal objective, as being the protection of the interests of existing and future consumers, wherever appropriate by promoting competition, and including their interests in the reduction of greenhouse gas emissions and the ensuring of the security of energy supply.

measures were not installed in people's homes by the end of the CESP compliance period. Whilst British Gas was installing energy efficiency measures as mitigation action from January 2013, it took until August 2013 (by contrast to the 31 December 2012 deadline for substantive compliance) to deliver all of the expected energy efficiency measures, meaning energy savings for some consumers were delayed.

- 4.5 This delay had a material impact on consumers, who experienced a particularly cold winter during the months of January to March 2013, with average temperatures below the long-term average from 1981 to 2010.<sup>11</sup>
- 4.6 During that cold winter, domestic consumers used more gas than during either of the previous two winters.<sup>12</sup>
- 4.7 Had British Gas met its target by 31 December 2012, it is estimated around 6,750<sup>13</sup> households would have benefited from energy efficiency measures under CESP on time. These households were 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.
- 4.8 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 noted that the case does not turn on this point.
- 4.9 The Authority also considered the extent to which harm caused to consumers will have been offset by over-delivery of mitigation activities. We consider this further in paragraphs 5.38-5.40 below.

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

- 4.10 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

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<sup>11</sup> <http://www.metoffice.gov.uk/climate/uk/summaries/anomalygraphs>. The Met Office publishes data on 30-year averaging periods, for 1961-1990, 1971-2000 and 1981-2010. Thus, 1981-2010 is the most recent data-set.

<sup>12</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/266718/et4\\_1.xls](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/266718/et4_1.xls)

<sup>13</sup> This figure is based on the number of properties treated by British Gas during 2013, in order for it to mitigate its compliance shortfall.

- (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

4.11 The Authority did not consider that British Gas’s failure to meet its CESP obligation was trivial. The Authority noted that British Gas’s shortfall as at 31 December 2012 was 2,129.700 ktCO<sub>2</sub>, which was equivalent to installing energy efficiency measures in around 6,750 households. This shortfall was larger in absolute terms than all of the other non-compliant CESP OPs’ shortfalls combined.

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

4.12 There is nothing in the Authority’s principal objective and duties as set out in section 3A of the Electricity Act 1989 that precludes the imposition of a penalty in this case.

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

4.13 The Authority considered that the breach or possibility of a breach would have been apparent to British Gas licensees. Companies 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.

4.14 In this case, the review of the evidence showed that British Gas’s senior management became aware of a real risk of non-compliance from December 2011. However, by April 2012, British Gas thought they had contracts in place to deliver 110% of their obligation by 31 December 2012. Then, in May 2012, British Gas updated their assessment of their position in a risk report which stated that they may only achieve 85% of their compliance target by 31 December 2012. Therefore, the Authority considered that the breach or possibility of a breach would have been apparent to a diligent licensee.

## Conclusion

- 4.15 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(1) 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 its penalty fell within the maximum statutory limit.
- 5.2 In deciding the appropriate level of financial penalty, the Authority considered all the circumstances of the case, including the amount of consumer redress in the sum of £10.6 million (minus the £1 financial penalty) and 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 British Gas's breach of CESP was very serious. Companies 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 British Gas incurred a shortfall of 2,129.700 ktCO<sub>2</sub> (see paragraph 1.4 above), the highest shortfall in absolute terms of all the CESP OPs. Unmitigated, that shortfall would have been 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 would have been detrimental to the UK's commitment under the Climate Change Act 2008 to reduce carbon emissions by 80% by 2050 compared to 1990 levels.

#### 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 4.4 to 4.9). Once British Gas had completed its CESP mitigation activities in August 2013, the period of consumer harm ceased.



### The duration of the contravention or failure

5.6 The breach of the obligation occurred at the deadline on 31 December 2012 when British Gas 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 persisted for over seven months afterwards, i.e., until British Gas's mitigation activities were complete.

### The gain (financial or otherwise) made by the licensee

5.7 The Authority considered whether or not British Gas made a financial gain through not meeting its CESP obligation by the statutory deadline. It considered this by reference to the specific facts surrounding British Gas' compliance strategy and costs that British Gas might have been expected to incur to achieve compliance.

5.8 The Authority noted that British Gas's average carbon costs during the mitigation period were greater than its average costs during the compliance period. The Authority also noted that British Gas incurred lower carbon costs during the entire CESP scheme than the companies that complied with their obligations and lower carbon costs than the average cost per tCO<sub>2</sub> secured in the final year of CESP by all OPs, or indeed those non-compliant OPs who mitigated their shortfalls in 2013. This is because it adopted a delivery strategy that was different to that of nearly all the other parties.<sup>14</sup>

5.9 However, in order to have met its obligation on time the Authority considered that British Gas would have had to incur higher costs than it paid in mitigation, bearing in mind the average prevailing market rate for CESP measures in 2012 and the levels of costs incurred during the compliance period by parties whose strategies were most similar to that of British Gas and who complied with CESP. This analysis is further supported by observing that British Gas's new mitigation schemes (as opposed to those schemes which continued from the compliance period) were similar in cost to schemes contracted in 2012.

5.10 Further, the Authority also considered that British Gas had gained, on a time value of money basis, by delaying a significant proportion of its CESP expenditure into the mitigation period. By not investing in CESP delivery in a manner that would have achieved compliance, British Gas would have been in a position to put the deferred expenditure to alternative use.

5.11 For these reasons the Authority considered British Gas made a significant financial gain.

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<sup>14</sup> The Authority noted that British Gas began delivering its obligation relatively early in the compliance period compared with other OPs, when the costs of schemes were lower. British Gas also received higher levels of client contributions and took greater advantage of the whole house bonus than all of the other OPs during the compliance period.

## ***Factors tending to increase the level of penalty***

### Repeated contravention or failure

5.12 British Gas had not previously failed to meet an energy efficiency obligation. The Authority did not consider that this aggravating factor applies.

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

5.13 The breach of the obligation occurred at 31 December 2012, when British Gas 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 breach continued for over seven months afterwards. The Authority did not consider that this aggravating factor applies.

### The involvement of senior management in any contravention or failure

5.14 From the review of evidence, the Authority considered that British Gas's senior management and the Board of Directors were involved in key decisions regarding the CESP delivery strategy. British Gas had reporting structures in place for CESP at multiple tiers of British Gas and the Centrica group. Updates were provided to senior management by the operational team, in the form of Monthly Business Reviews (MBRs), Quarterly Business Reviews (QBRs) and Quarterly Performance Reviews (QPRs).

5.15 In 2010, British Gas's senior management made a decision to take on additional CESP obligations from British Energy and GDF Suez which saw British Gas's overall obligation rise from 3.7 MtCO<sub>2</sub> to 5.7 MtCO<sub>2</sub>. This made British Gas's compliance target higher. It received money from these companies for taking on their obligations but ultimately made a loss on these acquisitions as it cost more per tonne to deliver the carbon savings than it had paid British Energy and GDF Suez for them.

5.16 British Gas had a budget planning process for CESP which involved the setting of 'cost efficiency targets'<sup>15</sup>, as specified in financial plans. The financial plans were referred to as 'latest estimate plans' (LE plans). The LE plans were reviewed and approved by the British Gas New Energy (BGNE) Managing Director and Finance Director, the British Gas Managing Director and Finance Director, and finally the Centrica CEO and Finance Director.

5.17 The Authority considered that cost efficiency targets from the LE plans compromised British Gas's ability to procure new schemes and caused a

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<sup>15</sup> British Gas said these 'targets' were used as a benchmark by its CESP commercial team when assessing whether a prospective opportunity represented good value for money. British Gas said they did not use them as absolute targets and there was scope to exceed them.

delay to British Gas in getting its CESP obligation fully under contract. This is because the cost efficiency targets were set at price levels well below prevailing market rates for CESP carbon, from Q4 2010 until the end of the compliance period. Although the Authority noted that the cost efficiency targets did not represent an absolute ceiling on the prices that British Gas was prepared to pay for its schemes, the Authority considered that British Gas did not do enough to respond to changes in market conditions or effectively manage its delivery when problems arose in 2012.

- 5.18 British Gas had 100% of its CESP obligation under contract by December 2011, and believed this would allow it to reach its carbon target on time. However, by May 2012, British Gas became aware that it was unlikely to achieve compliance, and anticipated a shortfall of around 15%. In the last six weeks of 2012, British Gas declined opportunities to buy CESP carbon from other OPs that had surplus carbon to sell. British Gas has since said that, with hindsight, its responses to these offers of carbon at the very end of 2012 might be considered to be an 'error of judgement'.
- 5.19 In 2012, British Gas sold a CESP scheme (Rotherham) to another OP. The size of this scheme was 16.6 ktCO<sub>2</sub>.
- 5.20 Based on the findings above, the Authority considered that British Gas's senior management and the Board of Directors were involved in British Gas's failure to achieve its CESP compliance target by 31 December 2012 and that this aggravating factor therefore applies.

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

- 5.21 British Gas has provided evidence to show that it had internal procedures/mechanisms in place to prevent contravention of CESP. Those internal mechanisms or procedures included:
- a) Clear management structures in place for the internal management of the CESP;
  - b) Regular reporting to senior management on the progress of CESP delivery, through the MBRs, QBRs and QPRs;
  - c) Use of risk management tools, such as maintenance of risk registers and regular risk monitoring at senior management level;
  - d) Establishing BGNE and 'British Gas Communities and New Energy' as the organisations responsible for delivering CESP; and
  - e) Making significant business acquisitions and forming a partnership with a facilities management company to increase the in-house ability to deliver CESP schemes.

5.22 Taking the above into account, the Authority did not consider that there is an absence of any evidence of internal mechanisms or procedures intended to prevent contravention or failure. The Authority did not consider that this aggravating factor applies.

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

5.23 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

5.24 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 subject to appropriate management supervision.

5.25 The Authority considered there is evidence that British Gas took steps to secure compliance including:

- a) Re-structuring to form a new business unit ('British Gas Communities and New Energy'), and making significant business acquisitions including insulation installers and social housing services providers;
- b) Monitoring its CESP delivery appropriately through monthly and quarterly business performance reviews, and project management tools such as risk registers and financial plans;
- c) Making a good start to CESP by completing 29 schemes in 2009-10 before those schemes had been approved by Ofgem;
- d) Putting contracts in place to deliver its full CESP obligation by December 2011; and
- e) Installing measures before the end of the compliance period which it was not able to bank and gain credit for in the compliance period, due to not having completed the necessary administrative processes.<sup>16</sup>

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<sup>16</sup> British Gas installed 8.6% of the required measures in the compliance period that it was unable to bank before the compliance deadline, due to not having completed all the necessary administrative processes.

- 5.26 However, the Authority also considered that when British Gas was setting its 'cost efficiency targets' during the CESP compliance period, as time went on it did not do enough to respond to changes in market conditions (in particular the clear signals that the cost of procuring these schemes had risen significantly above the prices set out in its budget). As a result, the cost targets compromised British Gas's ability to procure new schemes and caused a delay to British Gas in getting its CESP obligation fully under contract, and to respond when it realised that it was no longer on target to deliver and needed once again to find additional schemes.
- 5.27 The Authority considered that British Gas needed to have invested more in CESP delivery during the compliance period in order to meet its obligation by 31 December 2012. The Authority also noted that British Gas did not purchase any of the CESP carbon which was made available by other OPs, in the second half of 2012.
- 5.28 In view of the reasons above, the Authority considered that this mitigating factor partially applies.

#### Appropriate action by the licensee to remedy the contravention or failure

- 5.29 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 obligated parties 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.
- 5.30 The Authority noted that British Gas undertook mitigation equivalent to the volume of its shortfall associated with not achieving the carbon saving reduction target. This mitigation was completed by August 2013 i.e., after the key date of 30 April 2013. The Authority also noted that British Gas delivered more than its shortfall as mitigation (see paragraphs 5.38-5.40 below). In light of this, the Authority considered that British Gas did take appropriate action to remedy the breach and that this mitigating factor applies, albeit British Gas failed to complete delivery until after 30 April 2013 which was set out as a key date for assessing mitigation efforts in Ofgem's Open Letter.

#### Evidence that the contravention or failure was genuinely accidental or inadvertent

- 5.31 British Gas has made representations that factors including being let down by its suppliers and poor weather in the last few months of 2012 affected its ability to deliver the obligation by the due date. The Authority noted that OPs had over three years to secure compliance with CESP and there

has been no evidence to suggest that British Gas's contravention was genuinely accidental or inadvertent. Accordingly, the Authority did not consider that this mitigating factor applies in this case.

#### Reporting the contravention or failure to Ofgem

5.32 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 whether OPs had achieved their carbon emissions reduction targets. This report was duly presented and the OPs were notified of its conclusions. The Authority therefore considered that this factor did not apply.

#### Co-operation with Ofgem's investigation

5.33 British Gas 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 cooperation has gone beyond what would be expected of any licensee facing enforcement action<sup>17</sup>. In this case, British Gas has additionally, in response to the Settlement Mandate put forward, accepted its 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 considered that this mitigating factor applies and the Authority imposed a lower penalty (when considered in aggregate with consumer redress) than it would otherwise have imposed.

#### Other factors

5.34 It was the view of the Authority that the following additional factors tending to reduce the level of any penalty were relevant in this matter.

#### Design and administration of the CESP scheme

5.35 The Authority considered the extent to which the design and administration of CESP may have adversely affected British Gas's ability to deliver CESP by 31 December 2012. The Authority considered evidence including a report commissioned by DECC, Evaluation of the Carbon Emissions Reduction Target and Community Energy Saving Programme.<sup>18</sup>

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<sup>17</sup> 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> The Authority considers issues concerning the design and administration of CESP below (please see paragraphs 5.35-5.37).

<sup>18</sup> <https://www.gov.uk/government/publications/evaluation-of-the-carbon-emissions-reduction-target-and-community-energy-saving-programme>

- 5.36 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 included: 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.
- 5.37 The Authority considered that these factors were not insurmountable as several OPs secured compliance. Further, in the case of British Gas 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 a small mitigating factor should be applied to reflect these challenges.

#### Over-delivery of CESP mitigation measures

- 5.38 British Gas delivered mitigation actions in excess of the level required to address the harm associated with its breach. The Authority recognised that this additional delivery by British Gas provided enduring benefits for those 674 households who had received those measures.
- 5.39 At the same time the Authority was aware that in relation to CERT and CESP, compliant suppliers were able to carry forward part of any over-delivery of compliance actions into the ECO scheme albeit not necessarily on a pound for pound basis.
- 5.40 The Authority balanced both of these points and considered that a mitigating factor should apply.

## **6 The Authority's decision as to the level of penalty**

- 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 on British Gas a £1 Penalty on the basis that British Gas has made a payment of £10.6 million (less the £1 financial penalty) in consumer redress to BGET on 27 February 2015. The Authority considers this penalty to be reasonable in all the circumstances of the case. In reaching this decision the Authority considered in particular the following:
- (a) British Gas's failure to achieve the CESP target was a very serious contravention of a major environmental programme;
  - (b) The extent of the initial shortfall in delivery of carbon reduction measures by British Gas was 2,129.700 ktCO<sub>2</sub> or 37.6% of its obligation;

- (c) British Gas has made a significant financial gain from the breach and would have needed to have incurred higher costs to deliver all obligated measures by the end of the period;
- (d) British Gas undertook mitigation action equivalent to the volume of the shortfall associated with the breach, albeit this mitigation was not fully complete until August 2013 (after 30 April 2013 which Ofgem said would be a key date for assessing mitigation action);
- (e) British Gas has one aggravating factor (see paragraphs 5.14–5.20);
- (f) British Gas has several mitigating factors that apply (see paragraphs 5.29-5.30, 5.33, 5.35-5.37 and 5.38-5.40), and one mitigating factor that partially applies (see paragraphs 5.24-5.28);
- (g) British Gas has agreed to settle this investigation; and
- (h) British Gas has made a payment of £10.6 million (less the £1 financial penalty) in consumer redress as set out in paragraph 1.1.

In the judgement of the Authority the aggregate of the penalty and the amount of consumer redress is a lower figure than would have been the case if British Gas had not taken the steps as set out in paragraphs (d) and (g) above, and the aggregate of the penalty and the amount of consumer redress is larger than the detriment suffered by consumers and the gain made by British Gas.



## Annex:

### Representations or Objections on the Proposed Penalty

#### Introduction

1.1 The Authority received nine 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 1.3 to 1.6)
- The proposed Penalty Notice lacked transparency (see paragraphs 1.7 to 1.9)
- Points in relation to consumer redress (see paragraphs 1.10 to 1.16)
- Other matters (see paragraphs 1.17 to 1.18)

1.2 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

1.3 Five respondents submitted that the level of proposed penalty was too low. They contended that, in assessing the extent to which British Gas may have made a financial gain, the Authority should have compared British Gas'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.<sup>19</sup> 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 British Gas."*

1.4 The Authority's judgement is that this statement is correct and that the level of penalty for British Gas is reasonable in all of the circumstances. In assessing any financial gain made by British Gas, the Authority has considered the particular facts and circumstances of British Gas' compliance strategy.

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<sup>19</sup> See footnote 18 (paragraph 5.35).

- 1.5 Ultimately, the assessment of financial gain is by necessity a judgment taking into account a number of factors. In coming to its view that British Gas made a significant financial gain (see paragraphs 5.7-5.11) the Authority considered the suitability of a range of possible compliance scenarios British Gas could have adopted in order to have met its target on time, some with higher costs as has been suggested by some of the respondents, as well as some with significantly lower costs (as would have been the case, for example, by spreading delivery costs more evenly over the whole CESP period, or utilising different approaches to compliance). In reaching its decision that British Gas made a significant financial gain, the Authority was sensitive to the potential risk of incentivising inefficient compliance strategies, which may not be in the best interests of consumers.
- 1.6 In relation to the point about sending a clear signal about the importance of compliance, 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

- 1.7 A number of respondents submitted that the proposed penalty notice needed a greater level of detail<sup>20</sup> in order to enable respondents to comment meaningfully on the level of penalty and/or consider whether British Gas gained an unfair advantage from not complying.
- 1.8 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 requirements<sup>21</sup>, namely that the Authority states in its Notice:
- (i) 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.

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<sup>20</sup> For example, the penalty notice should quantify each element of the proposed penalty and should state British Gas's 'mitigation costs'.

<sup>21</sup> In section 27A Electricity Act 1989.

- 1.9 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

- 1.10 A number of respondents made a number of points in relation to the consumer redress British Gas is proposing. These points are considered below.
- 1.11 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.
- 1.12 Several respondents submitted representations requesting that they should receive redress monies. The Authority considered that it was for British Gas to choose its redress recipients subject to the funding meeting the objectives referred to in paragraph 1.1.
- 1.13 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 pursue the objectives referred to in paragraph 1.1 of this Penalty Notice. 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 Obligation (ECO), or create an unreasonable administrative burden for Ofgem.
- 1.14 The Authority is satisfied that British Gas's proposal is within the scope of this mandate. The Authority notes that the BGET will be able to fund suitable projects involving "hard" energy efficiency measures, in addition to those involving more general advice and support. Further, the Authority notes that British Gas undertook mitigation action in excess of the volume of the shortfall associated with its breach meaning that the original CESP objectives have been met and additional "hard measures" have been installed in any event.
- 1.15 A number of respondents considered it inappropriate for British Gas to make consumer redress through the BGET. However, the Authority notes that British Gas has given a senior Board-level assurance that the redress payment will not displace existing charitable funding, and that the BGET will be open to suitable applications from organisations matching at least one of the objectives set out in paragraph 1.1 above. Further, the Authority would be concerned if British Gas sought to derive any inappropriate publicity benefits from the payment to the BGET. The Authority notes from due diligence conducted by Ofgem that the BGET has

a satisfactory track record and that other safeguards will be put in place to protect consumers' interests as part of the redress package.

- 1.16 One respondent said that consumer redress should be targeted at the Scottish Highlands & Islands to reflect the geographical areas where, in its view, British Gas failed against the CESP target. The Authority notes that, whilst CESP was an obligation across all three nations of Great Britain, the obligation did not mandate delivery in particular nations or regions. Nevertheless, the Authority accepts that it is important that there is a wide geographical spread for the consumer redress and notes that steps have been taken to facilitate this.

#### Other matters

- 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 raised concerns that a non-compliant supplier should not be able to receive any credit for CESP mitigation which had also been claimed by the supplier under the ECO; and
- (d) 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 British Gas for it 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 paragraphs 5.14-5.20).
- (c) Regarding the possibility of a non-compliant supplier submitting the same activity as both substantive ECO compliance and CESP mitigation, Ofgem has been unable to identify any duplicate measures based on its records.
- (d) 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.

**Gas and Electricity Markets Authority**

**5 March 2015**