

Notice under section 27A of the Electricity Act 1989

Decision of the Gas and Electricity Markets Authority to impose a financial penalty, following an investigation into compliance with SLC 4D, SLC 12 and SLC 30 of the electricity distribution licence by Scottish Hydro Electric Power Distribution plc

13 April 2011

1. Summary

- 1.1. This is the decision of the Gas and Electricity Markets Authority ("the Authority") following an investigation into compliance by Scottish Hydro Electric Power Distribution ("SHEPD") with its licence obligations under its electricity distribution licence, specifically standard licence condition 4D ("SLC 4D"), standard licence condition 12 ("SLC 12") and standard licence condition 30 ("SLC 30").
- 1.2. The obligation on licensees in SLC 4D and SLC 12 is to provide offers for connection as soon as practicable/reasonably practicable and in any event within three months of receipt of an application which contains all such information as the licensee may reasonably require for the purposes of formulating the offer¹. SLC 30 requires a licensee to have available to itself such "resources, including management and financial resources...as will enable it to...comply in all respects with its obligations under this licence".
- 1.3. Ofgem's investigation concerned applications and offers for connection made from 1 July 2004 to 15 July 2009, and the monitoring systems that were in place to ensure compliance with the obligations regarding connection offers. During this period SHEPD received 48,593 enquiries regarding connection applications.
- 1.4. SHEPD entered into a settlement agreement with Ofgem by which SHEPD has agreed not to contest Ofgem's findings as set out in this decision.
- 1.5. The Authority finds that:
 - SHEPD did not have appropriate monitoring systems in place to enable it to comply with its obligations under the electricity distribution licence, in breach of SLC 30;
 - There have been 18 cases where SHEPD has breached the three month timeframe required in SLC 12; and
 - There have been six cases where SHEPD has breached the three month timeframe required in SLC 4D.
- 1.6. The Authority considers it appropriate to impose a penalty on SHEPD for the above breaches.

¹ Prior to June 2008 the obligations under SLC 12 were contained in SLC 4D.

- 1.7. The Authority gives significant weight to SHEPD's cooperation with Ofgem's investigation in this case, including its willingness (and agreement) to settle this investigation.
- 1.8. The Authority announced on 7 February 2011 that it intended to impose a penalty of £500,000 on SHEPD in respect of contraventions of its licence conditions which the Authority considers took place in this case after 15 July 2008².
- 1.9. No representations were received to the Authority's proposal. The Authority has decided to confirm the penalty of £500,000 on SHEPD.
- 1.10. The penalty must be paid by 26 May 2011.

2. Background

- 2.1. DNOs are natural monopolies with respect to a number of services where it is more efficient for a single company to provide the service than it would be for several competing companies. Examples of such "non-contestable" activities carried out by DNOs include deciding the point of connection to the DNO's network and the design, approval and connection of extension assets to the DNO distribution system and their energisation.
- 2.2. Ofgem considers it is important for both customers and the evolution of competition in connections that the incumbent DNO does not misuse its monopoly power in the provision of non-contestable services, and that it provides offers for those services in accordance with the relevant licence condition. Ofgem's enforcement powers serve to provide an important incentive to DNOs to comply with their obligations.
- 2.3. In November 2008 SHEPD asked Ofgem to consider granting a derogation from the three month time limit provided in SLC 12, on the basis of a significant increase in the number of connections applications following the suspension of Assessment and Design (A&D) Fees in August 2008. During the subsequent correspondence it became apparent that SHEPD might have breached its obligations to provide timely connection offers in a number of cases.
- 2.4. On the basis of the evidence collected during the investigation, Ofgem has concluded that SHEPD is unable to demonstrate compliance with SLC 4D and SLC 12 between July 2004 and July 2009 in a large number of cases because of various weaknesses in its systems, processes and management oversight during the period in question. Ofgem considers that this constitutes a breach of SLC 30 which requires a licensee to have available to itself sufficient resources, including management and financial resources, so that it can comply in all respects with its obligations under its licence.
- 2.5. SHEPD has accepted that there were weaknesses in its systems and processes. During the penalty period (15 July 2008 to 15 July 2009), SHEPD has admitted to 1 demand case where it breached SLC 12, 23 demand cases where it was unable to demonstrate compliance with SLC 12 and 79 DG³ cases where it was unable to

² The Authority may not impose a penalty in respect of instances of breach where the time of the contravention was prior to 15 July 2008. This is because 15 July 2009 was the date on which Ofgem sent out its first information request to SHEPD under section 28 (2). While the Authority can only impose a penalty in relation to breaches where the time of the contravention was on or after 15 July 2008, it is open for the Authority to find breaches which occurred previous to this point as a matter of fact.

demonstrate compliance with SLC 12. Prior to the penalty period (between July 2004 and 14 July 2008), SHEPD identified a further 6 demand cases where it breached SLC 4D/12 and 5 DG cases where it is unable to demonstrate compliance with SLC 4D/12.

- 2.6. In addition, 1045 demand cases were identified where an initial interrogation of SHEPD's IT system suggested that the time taken from initial contact from the customer to the date the quotation was issued was longer than three months. Without interrogating the system further and reviewing all of the paper files, SHEPD was unable to demonstrate compliance or non-compliance with SLC 4D/SLC 12 in each of these cases.
- 2.7. In order to determine whether there were breaches of SLC 12 other than the cases reported by SHEPD Ofgem has examined carefully the case files for 25 demand applications, and has spoken to SHEPD's customers in relation to 17 DG applications, where the time taken from the date of the initial contact regarding connection and the date on which the offer was made exceeds three months. For 17 cases (two demand cases and 15 DG cases) Ofgem considers that SHEPD has breached SLC 12 (in addition to the one case reported by SHEPD).
- 2.8. On that basis, the Authority finds that:
 - SHEPD did not have appropriate monitoring systems in place to enable it to comply with its obligations under the electricity distribution licence, in breach of SLC 30;
 - There have been 18 cases where SHEPD has breached the three month timeframe required in SLC 12; and
 - There have been six cases where SHEPD has breached the three month timeframe required in SLC 4D.
- 2.8 Some steps were taken by SHEPD in Autumn 2008 to remedy the problem when it first became aware that there was an issue with compliance. However, SHEPD was unable to demonstrate full compliance with the relevant timescales until August 2009. SHEPD has now implemented a recovery plan which ensured responded to all outstanding connections, and that it is both compliant and able to demonstrate compliance with the three month requirement in the future.

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

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

- 3.1. The Authority has considered whether the imposition of a financial penalty is reasonable in all the circumstances of this case, in accordance with the requirements of the Electricity Act 1989 and having regard to its published Statement of Policy ("Policy") with respect to Financial Penalties.
- 3.2. The Authority is required to carry out all its functions, including the taking of any decision as to penalty, in the manner which it considers is best calculated to further its principal objective, having regard to its other duties. The Authority is not, under its own Policy, limited to consideration of matters specifically mentioned in the Policy, but will consider all the circumstances. The matters detailed in this policy are considered below.

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

Whether the contravention or the failure has damaged the interests of consumers or other market participants

- 3.3. The Authority finds that the general interests of consumers are likely to have been damaged by the contravention. Compliance with the provision to provide offers as soon as reasonably practicable, and in any event within three months, is an important service for customers, such as developers of housing estates or wind farms, who require certainty over the time of connection offers in order to manage their project schedules. By failing to devote sufficient resources to having appropriate systems in place SHEPD has failed to provide this service to the required standard as stipulated in its electricity licence, even though it was paid for it under the price control.

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

- 3.4. The Authority considers that imposing a financial penalty on SHEPD is likely to incentivise compliance and help deter future breaches by sending a message to the company, its shareholders and the industry at large that a failure to deliver services under the licence obligations will not be tolerated.

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

If the contravention is trivial in nature

- 3.5. The Authority considers that the contraventions cannot be described as "trivial". Through a review of the evidence, Ofgem established that there were 18 breaches of SLC 12 within the penalty period and six breaches of SLC 4D outside the penalty period. There are also a large number of cases where SHEPD is unable to demonstrate compliance due to weaknesses in its systems and processes as explained in paragraph above 2.6.

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

- 3.6. There is nothing in the Authority's principal objective and duties to preclude 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

- 3.7. The Authority considers that if SHEPD had had adequate systems and processes in place, as is expected from a diligent licensee, it would have been in a position both to comply and to demonstrate compliance with SLC 4D and SLC 12. During the investigation SHEPD accepted that its systems and processes were historically weak and that this is the main reason why it is unable to demonstrate compliance in a large number of cases.
- 3.8. In light of the above, the Authority considers it appropriate to impose a financial penalty in this case.

4. Criteria relevant to the level of financial penalty

- 4.1. Under the Electricity Act 1989 the Authority may impose a financial penalty of up to 10 per cent of the annual turnover of the relevant licence holder. Annual turnover is defined in Regulations issued by the Secretary of State⁴. The Regulations allow the inclusion of all revenue from the activities of the licence holder, whether regulated or not. In the year ended 31 March 2010 SHEPD had a turnover of £247m according to regulatory accounts. On this basis, the maximum fine leviable is £24.7m.
- 4.2. In arriving at the quantum of the penalty in this case, the Authority has considered the following factors in accordance with its Policy. It notes that the factors set out in its Policy do not preclude the Authority from considering other factors. It has also taken the view that it may consider potential harm under this section of its Policy, and that the potential for harm will be part of the reason why the relevant condition was imposed in the first place. Given the nature of this case, the potential harm has not been a significant factor in determining the level of the penalty.

Factors which are first considered when determining the level of penalty

The seriousness of the contravention and failure

- 4.3. It is the Authority's view that the contravention is of a serious nature. SHEPD is a monopoly network operator and provides a vital service. Many people are dependent on it, and on non-contestable work it faces no competition, while on other contestable work there is only limited competition. SHEPD is funded under the existing price control to deliver good customer service and the licence obligations reinforce this.
- 4.4. The compliance with the licence obligations is an important part of the integrity of monopoly network regulation. Ofgem expects that licensees deploy sufficient resources on systems, processes or mechanisms in order to ensure that they comply with the licence obligations. Ofgem maintains that these obligations include the effective monitoring and review of the time taken to provide connection offers.
- 4.5. SHEPD has told Ofgem that it is unable to demonstrate compliance with SLC 12 or SLC 4D in 79 DG cases and 23 demand cases between July 2008 and July 2009. There is also a large number of cases outside the penalty period where SHEPD is unable to demonstrate compliance with SLC 4D, as explained in paragraph 2.6 above. In Ofgem's view, the fact that SHEPD is unable to demonstrate compliance in such a large number of cases is indicative of the seriousness of the breach.

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

- 4.6. The Authority believes that it is likely that there was harm to consumers as a result of SHEPD's contravention. It is difficult to reach firm conclusions as to the fact and the extent of potential harm because the information recorded and retained by SHEPD on the case files was sparse and incomplete.

⁴ The Electricity and Gas (Determination of Turnover for Penalties) Order 2002

The duration of the contravention or failure

- 4.7. The Authority considers that there are at least 18 breaches of SLC 12 where the time of the contravention occurred on or after 15 July 2008. As explained in paragraph 4.5 above, the evidence collected by Ofgem during this investigation suggests that SHEPD is unable to demonstrate compliance with SLC 4D and SLC 12 in a large number of cases between July 2004 and July 2009. The Authority therefore considers that there was an ongoing breach of SLC 30 occurring where the time of the contravention occurred on or after 15 July 2008.

The gain (financial or otherwise) made by the licensee

- 4.8. The Authority concludes that SHEPD was unable to meet the service standards prescribed in its licence because it did not have adequate systems and processes in place to monitor compliance. To the extent that having these systems and processes in place involves the commitment of company resources, or additional opex or capex expenditure, there is an element of avoided cost associated with SHEPD's failure to comply.

Factors tending to increase the level of penalty

Repeated contravention or failure

- 4.9. There have been repeated contraventions in this case: a total of 18 breaches and 102 cases where SHEPD is unable to demonstrate compliance within the penalty period. Also, as explained in paragraph 4.7 above, the Authority considers that there was an ongoing breach of SLC 30 occurring where the time of the contravention occurred on or after 15 July 2008.

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

- 4.10. On 13 March 2009 SHEPD informed Ofgem that it had responded to all outstanding connections applications and that it would meet its obligations in the future. Despite this assurance, in a letter dated 4 August 2009, following a review of information dating back to July 2004, SHEPD stated that it had discovered a further 36 potential breaches where it believed that it may not have offered terms for connection within three months, including a further 23 potential breaches which had occurred since the reassurance provided in the letter dated 13 March that it would meet its obligations.

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

- 4.11. The Authority notes that in the course of the investigation SHEPD has made a number of statements which attributed its inability to demonstrate compliance with SLC 4D and SLC 12 to various weaknesses in its monitoring and recording processes and systems, and to a lack of management oversight.

The involvement of senior management in any contravention or failure

- 4.12. The Authority considers that senior management were not involved in any deliberate actions in relation to the contraventions or failures.

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

- 4.13. SHEPD drew the contravention to Ofgem's attention and did not attempt to conceal any contravention from Ofgem.

Factors tending to decrease the level of penalty

Co-operation with Ofgem's investigation

- 4.14. SHEPD has co-operated fully with Ofgem over the course of the investigation providing Ofgem with detailed information, both on a voluntary basis and in response to formal information requests. It also attended a meeting with Ofgem staff where issues relating to the investigation were discussed. Because SHEPD decided not to contest Ofgem's findings, Ofgem did not have to expend additional resources on responding in detail to SHEPD's comments on the SOC and on preparing for an oral hearing. The Authority also gives weight to SHEPD's willingness (and agreement) to settle this investigation on the basis of this proposed decision.

Appropriate action by the licensee to remedy the contravention or failure

- 4.15. SHEPD has, since discovering the breaches, spent a considerable amount of time and money on upgrading its systems and processes. It has implemented a full recovery plan to ensure that it is compliant and can demonstrate compliance with the three month requirement. This has involved an interim plan whereby modifications were made to its existing system, and a longer term plan to develop a comprehensive new IT system which is now in place.

Evidence that the contravention or failure was genuinely accidental or inadvertent

- 4.16. The Authority recognises the fact that SHEPD's breach was not wilful. However, it should have taken adequate steps to ensure compliance and the licence breaches were not accidental or inadvertent.

Reporting the contravention or failure to Ofgem

- 4.17. The Authority recognises that the contravention came to light after SHEPD wrote to Ofgem requesting that Ofgem extend the three month period in which SHEPD is required to provide a formal offer for connection because it experienced a significant increase in the volume of applications from developers and consultants following the suspension of A&D Fees in August 2008.

5. The Authority's decision on financial penalty

- 5.1.1. The Authority has decided to impose a financial penalty on SHEPD of £500,000, which it considers is reasonable in all the particular circumstances of this case. This is a lower figure than would have been imposed if the company had contested Ofgem's findings. The penalty represents 0.2% of SHEPD's total turnover and 2.6% of its connections revenue⁵.

⁵ Based on regulatory accounts year ended 31 March 2010.

5.2. The penalty must be paid by 26 May 2011.

Gas and Electricity Markets Authority

13 April 2011