

## **Notice under section 30A(5) of the Gas Act 1986**

### **Decision of the Gas and Electricity Markets Authority to impose a financial penalty, following an investigation into compliance by National Grid Gas plc with Special Conditions E2B, E6 and E20, Standard Special Condition D9 and A40 of its gas transporter licence in respect of its Distribution Networks (the "licence")**

**13 May 2011**

#### **1. Summary**

- 1.1. The Gas and Electricity Markets Authority ("the Authority") has imposed a financial penalty on National Grid Gas plc ("NGG") and found it in breach of its licence obligations. This follows an investigation into compliance by NGG with the obligations under Special Conditions E2B, E6 and E20 and Standard Special Conditions D9 and A40 of its licence relating to the reporting of NGG's mains decommissioning activities.
- 1.2. Under those provisions of its licence, NGG was required to provide to Ofgem for each regulatory year a report of the mains decommissioning work completed by NGG in that year.
- 1.3. The ability of regulators to rely on accurate information from regulated companies is a fundamental part of the regulatory regime. The Authority therefore regards any contraventions of the obligations on regulatory information as serious.
- 1.4. Ofgem conducted and completed an extensive investigation into NGG's regulatory reporting in this context for the years 2005/06, 2006/07 and 2007/08. A key part of that investigation was a report by Ernst and Young (EY) jointly commissioned with NGG. Although NGG does not agree with all the findings made by EY or by Ofgem, NGG has entered into a settlement agreement with Ofgem by which NGG has agreed not to contest Ofgem's findings as set out in this decision.
- 1.5. The Authority found that NGG contravened the provisions of Special Conditions E2B, E6 and E20 and Standard Special Conditions D9 and A40 of its licence during the relevant period.
- 1.6. The Authority considered it appropriate to impose a penalty on NGG for these contraventions. It published a notice on 6 January 2011 describing its proposal to do so. One representation was received, from Scottish and Southern Energy plc. The Authority considered this representation carefully and decided that it should confirm the proposed penalty of £8,000,000.
- 1.7. The Authority gave significant weight to NGG's cooperation with Ofgem's investigation in this case including its willingness (and agreement) to settle this investigation.
- 1.8. In the circumstances, the Authority hereby gives notice under section 30A(5) of the Gas Act 1986 of its decision to impose a penalty of £8,000,000 on NGG in respect of contraventions of its licence conditions which the Authority considers took place in this case after 18 November 2007.
- 1.9. The penalty must be paid by 27 June 2011.

## **2. Background**

- 2.1. NGG conducted (and is conducting) a programme to replace all spun/cast and ductile iron gas mains within 30m of habitation within its gas distribution networks, as required by the Health and Safety Executive, in order to reduce the risk of pipe fracture and resulting gas releases and explosions. NGG delivers the mains replacement programme by means of Gas Distribution Alliances (“the Alliances”) between NGG and third party contractors, which are managed and staffed by a combination of NGG employees and staff from the chosen contractual partner, TERM contractors (Transco Emergency Repair and Maintenance contracts) and NGG direct labour.
- 2.2. NGG recovers the costs of undertaking its activities, including the mains replacement programme, by levying distribution charges on gas shippers, which are ultimately passed onto customers. Paragraph 6.4.3 sets out the Authority’s finding in respect of damage to consumers and other market participants.
- 2.3. As part of the price control process Ofgem sets the maximum allowed revenue the companies can pass through the regulated component of their distribution charges. A component of this is revenue associated with the mains replacement programme where Distribution Networks are funded for the amount of main decommissioned. As such, accurate reporting of mains replacement activities is essential to Ofgem in reviewing the Distribution Networks’ allowed revenues.
- 2.4. NGG informed Ofgem on 7 November 2008 that allegations had been made by an NGG employee in a telephone call to NGG’s Business Conduct Helpline that decommissioning work conducted in the course of the mains replacement programme had been “forward-booked” by one of the Alliances, namely reported as completed in 2007/8 when in fact it was completed in 2008/9. Ofgem opened a formal investigation into the alleged misreporting on 18 November 2008 by issuing an information request to NGG under section 38 of the Gas Act 1986, seeking further information regarding the alleged misreporting and its impact on NGG’s regulatory reporting to Ofgem.
- 2.5. On 25 November 2008 NGG engaged EY to conduct an independent inquiry into the alleged misreporting on behalf of NGG. Subsequently NGG and Ofgem agreed to appoint EY jointly, and recorded the terms of EY’s joint appointment by letter dated 31 January 2009, to investigate the allegations of misreporting with a duty of care to both NGG and Ofgem, but funded by NGG. EY’s final report was provided on 18 December 2009. Ofgem continued its own investigation alongside EY’s inquiry, including site visits to NGG premises, issuing ten formal information requests and reviewing the underlying evidence collected by EY in the course of preparing its final report.
- 2.6. NGG also conducted an internal investigation into an aspect of the alleged misreporting concerning its DR4 asset error correction management procedure (“DR4”). NGG engaged an independent consultant to review the results of the investigation and prepare a report of the findings, which was dated 7 May 2010, and provided to Ofgem on the same date.
- 2.7. Ofgem concluded its investigation and communicated its findings to NGG. Following a number of discussions, NGG entered into a settlement agreement with the Authority.

### 3. The contraventions

- 3.1. The Authority has found that NGG breached the obligations in its licence when carrying out work under the mains replacement programme as set out below.

*Misreporting of decommissioning statistics by forward booking – 05/06 and 06/07*

- 3.2. NGG breached Special Conditions E2B and E6 and Standard Special Condition D9(5)(c) of its licence as follows:

- 3.2.1. in its regulatory reporting packs for the financial years 2005/06 and 2006/07 (submitted to Ofgem on 31 July 2006 and 31 July 2007 respectively), NGG claimed to have decommissioned 6.5868km and 13.743 km lengths of main in those years when in fact those lengths had been 'forward-booked', in the sense that the work was in fact completed in subsequent financial years;

- 3.2.2. on those dates, the conditions of NGG's licence imposed on NGG obligations to report to Ofgem the following:

- (a) the lengths of main decommissioned in the relevant financial year (as required by SC E6, SC E2B and SSC D9);
- (b) the number of kilometres of replacement mains installed in the relevant financial year (as required by SSC D9);
- (c) the costs reasonably attributable to the replacement and decommissioning of mains (i.e. "out-turn mains costs") (as required by SC E6 and SC E2B); and
- (d) NGG's "mains replacement expenditure adjustment", representing the expenditure incurred by NGG in the mains replacement programme (as required by SC E6 and SC E2B);

- 3.2.3. the Authority found that in providing inaccurate reports regarding the lengths of main decommissioned during the financial year 2005/06 and the financial year 2006/07, NGG failed to comply with each of those obligations, and therefore contravened the provisions of its licence;

*Misreporting of decommissioning statistics by duplicate reporting – 05/06*

- 3.2.4. during the course of the investigation, NGG identified that 4.086km of mains were mistakenly misreported as decommissioned in 2005/06, when in fact those mains had already been decommissioned (and reported as such) in 2004/05;

- 3.2.5. the Authority found that the duplicate claims raised by NGG represent decommissioning work which was mistakenly re-claimed such that NGG has failed to comply with those obligations relating to decommissioning described in the section above, and therefore contravened the provisions of its licence;

*Misreporting of decommissioning statistics by forward booking and of DR4 decommissioning work – 07/08*

- 3.2.6. furthermore, NGG breached Special Condition E20(7)(a) of its licence in respect of the 07/08 financial year as follows:

- (a) in its revenue reporting pack for the financial year 2007/08 (submitted to Ofgem on 31 July 2008), NGG claimed to have decommissioned 45.856km in the financial year 2007/08 when in fact those lengths had been 'forward-booked', and the relevant work was in fact completed in subsequent years. It also claimed 4.035km of decommissioning work under its DR4 process which in Ofgem's view was inaccurate;

(b) at the time of submitting that pack, Special Condition E20(7)(a) of NGG's licence imposed on NGG an obligation to report to Ofgem the following:

- (i) the lengths of main decommissioned in the relevant financial year;
- (ii) the costs reasonably attributable to the replacement and decommissioning of mains in 2007/08 (i.e. "out-turn mains costs"); and
- (iii) NGG's "mains and services replacement expenditure adjustment", representing the expenditure incurred by NGG in the mains replacement programme;

3.2.7. the Authority found that in misreporting the amount of mains decommissioned during the financial year 2007/08, NGG failed to comply with each of those obligations, and therefore contravened the provisions of Special Condition E20(7)(a) of its licence.

*Failure to accurately report DR4 workload – 05/06, 06/07*

3.2.8. NGG was unable to confirm the accuracy of 9.327km of decommissioning it claimed to have completed in 2005/06 (on 31 July 2006) and 2006/07 (on 31 July 2007) in respect of pipes claimed under the DR4 asset error correction process. Accordingly the Authority found that through being unable to confirm the accuracy of those claims, NGG has failed to comply with the requirements of Special Condition E6, Special Condition E2B and Standard Special Condition D9(5)(c) of its licence as set out above.

*Failure to accurately report DR4 workload – 07/08*

3.2.9. in addition, NGG was unable to confirm the accuracy of claims it made to have decommissioned 13.83km of mains in 2007/08 under the DR4 asset error correction procedure. The Authority found that, through being unable to confirm the accuracy of those claims, NGG has failed to comply with the obligations under Special Condition E20(7)(a) set out above.

*Failure to maintain adequate systems, processes and procedures in the mains replacement programme*

*(pre 1 April 2008)*

3.3. The Authority found that NGG breached Standard Special Condition D9(2) of its licence by failing to put in place and maintain appropriate systems, processes and procedures for accurately recording lengths of mains decommissioned. From FY 2005/06 until 1 April 2008 NGG was required by Standard Special Condition D9(2) of its licence to "establish appropriate systems, processes and procedures to measure and record [mains decommissioning information]".

3.4. The Authority found that NGG failed to put in place and maintain appropriate systems, processes and procedures for accurately recording lengths of mains decommissioned during the period from FY 2005/06 until 1 April 2008, and accordingly that NGG contravened the requirements of SSC D9(2) of its licence during that period.

*Systems processes and procedures in the mains replacement programme*

*(post 1 April 2008)*

3.5. From 1 April 2008 NGG was required by Special Conditions E20(3)(b) (with a focus on revenue reporting) and A40(5) (with a focus on cost reporting) of its licence:

- (a) to “maintain all systems of control and other governance arrangements that ensure that information collected and reported to the Authority is in all material respects accurate and complete” (“the E20/A40 systems obligation”); and
- (b) to “ensure that [...] all such systems of control and other governance arrangements are kept under regular review by the directors of the licensee with a view to ensuring that they remain effective for this purpose” (“the E20/A40 review obligation”).
- 3.6. The Authority considers that from the entry into force of SC E20 and SSC A40(5) on 1 April 2008 until more recently, NGG failed to maintain adequate systems, procedures and processes to ensure that mains decommissioning information collected and reported to the Authority was accurate, and therefore contravened the E20 and A40 systems obligation.
- 3.7. In making these findings, the Authority considered the detailed findings from the investigation conducted by Ofgem and the report produced by EY.
- 3.8. The Authority notes that NGG has taken significant steps to address the issues outlined above. These include enhancements to policies and procedures, measures to monitor compliance, greater management oversight and other measures.
- 3.9. Having reviewed NGG’s plans, the Authority is satisfied that NGG has taken all the necessary steps to restore compliance and that it is no longer contravening these obligations.

#### **4. Representations from Scottish and Southern Energy plc (SSE)**

- 4.1. The Authority has considered carefully representations from SSE on its proposal to impose a penalty of £8,000,000 and has taken them into account in reaching a final decision on imposing a penalty in this case. SSE expressed concern about the level of the financial penalty and its relativity with the nature of the contraventions. The Authority considers that a penalty of £8,000,000 is proportionate to the breach and reflects the co-operation of NGG. It does not consider that there is any new evidence in SSE’s representations which would cause it to modify its original proposal.

#### **5. The Authority’s decision on whether to impose a financial penalty**

- 5.1. The Authority has considered whether a financial penalty is appropriate in accordance with the requirements of the Gas Act 1986 and with its published Statement of Policy with respect to Financial Penalties (October 2003). In particular, it has had regard to the factors below.

##### *Damage to consumers and other market participants*

- 5.2. Misreporting or inaccurate reporting of regulatory information by any regulated company has the potential to lead to allowances being granted under the price control laid down by Ofgem which are not justified by underlying activity. This would potentially damage, at least initially, the interests of direct customers (e.g. Gas shippers) and also of consumers, who are among the ultimate purchasers of the gas. Paragraph 6.4.3 sets out the Authority’s finding in respect of damage to consumers and other market participants.

*Potential incentive for compliance*

- 5.3. Misreporting or inaccurate reporting of regulatory information by any regulated company is difficult for Ofgem to detect, and may lead to significant detriment to other market participants and to consumers should it go undetected for significant amounts of time. It is therefore necessary that regulated entities are deterred from misreporting or inaccurate reporting and are incentivised to ensure that their systems, processes and procedures are adequate to ensure accurate reporting of regulatory information. The Authority considers that the imposition of penalties where misreporting or inaccurate reporting comes to light, as in this case, is likely to have this effect.

*Whether the breach was trivial*

- 5.4. The Authority considers that the infringements of NGG's licence conditions which the Authority has found are not trivial due to the Authority's reliance on the accuracy of regulatory information in order to carry out its functions.

*Whether the Authority's objectives or duties preclude the imposition of a penalty*

- 5.5. The Authority does not consider that its objectives or duties preclude the imposition of a penalty. In fact, the Authority considers that its principal objective reinforces the need for a penalty in this case.

*Whether the breach would have been apparent to a diligent licensee*

- 5.6. Much publicity has been given to the need for accurate reporting by regulated entities in recent years. NGG's parent company, National Grid plc, was made aware of regulatory decisions taken by Ofwat in relation to misreporting in 2006, and has corresponded with Ofgem, providing assurances that the quality and integrity of its regulatory data is of a very high standard.
- 5.7. The Authority therefore considers that NGG, along with other regulated entities, was on notice of the importance of ensuring compliance in this area.
- 5.8. Moreover, NGG's licence expressly confers on NGG responsibility for its systems, processes and procedures in the mains replacement programme and reporting, and thus NGG is required to keep this under control and review. The findings in Ofgem's investigation outlined above indicate that NGG did not act as a diligent licensee in maintaining and keeping under review systems for recording and reporting accurate information regarding mains replacement. NGG has argued that it could not have operated on the basis that individuals would take deliberate steps to circumvent its controls, and that it is very difficult for an internal control environment to prevent such steps. However, the Authority takes into account the fact that whilst EY found evidence of deliberate misreporting only in relation to a proportion of the inaccurate reporting identified, it is also possible that a proportion of the remaining inaccurate reporting occurred as a result of clerical error.

*Conclusion*

- 5.9. For these reasons, the Authority has decided to impose a penalty on NGG in the present case in respect of the contraventions of its licence conditions described above.
- 5.10. By virtue of section 30C(1)(b) of the Gas Act 1996, the Authority may not impose a penalty in respect of contraventions of NGG's licence conditions which took place more than 12 months prior to the date of Ofgem's first information request

of 18 November 2008. Accordingly the Authority has decided only to impose a penalty in respect of NGG's contraventions of its licence conditions which took place from 19 November 2007 until recently.

## **6. Criteria for fixing the quantum of a penalty**

- 6.1. By virtue of section 30A(1) and 30A(8) of the Gas Act 1986, any penalty imposed by the Authority must be "of such amount as is reasonable in all the circumstances of the case", and must not exceed 10% of the licensee's applicable turnover.
- 6.2. The relevant applicable turnover is defined in Regulations made by the Secretary of State as turnover derived by the licence holder (in this case NGG) from the provision of goods and services falling within its ordinary activities (whether or not pursuant to a licence) for the business year preceding the date of the statutory notice of the Authority's intention to impose a penalty. In the particular circumstances of the present case, the Authority proposes to adopt as the applicable turnover NGG's turnover from its Gas Distribution business (although it would be open to the Authority to adopt the entire turnover of NGG). This is on the basis that the misreporting only occurred within NGG's Gas Distribution business. For the financial year 2009/10, the relevant applicable turnover was therefore £1,516m.
- 6.3. In arriving at the quantum of a penalty in this case, the Authority has taken into account the following factors, in accordance with its published penalty policy.

### *Starting point*

- 6.4. The Authority considered first the following factors in determining the general level of the penalty:
  - 6.4.1. the seriousness of the contraventions. The Authority considers that the contraventions in this case are serious. Ofgem relies on the submission of accurate information by regulated entities in order to enable Ofgem to carry out its statutory functions and to set the charges which NGG may levy from its customers. Misreporting or inaccurate reporting of regulatory information by NGG has the potential to lead to charges set pursuant to Ofgem's price controls which are not justified by NGG's underlying activities, and therefore may lead to unjustified charges being levied by NGG from its customers. This may have knock-on detrimental effects on consumers who are among the ultimate purchasers of the gas distributed by NGG. Ofgem also relies on its ability to make comparisons and measure relative performance in costs and delivery of outputs. Paragraph 6.4.3 sets out the Authority's finding in respect of damage to consumers and other market participants;
  - 6.4.2. in addition, NGG has failed to maintain adequate systems, processes and procedures in the mains replacement programme, to ensure accurate regulatory reporting. The importance of accurate reporting by regulated entities as well as instances of misreporting in other sectors were expressly brought to NGG's attention in letters from the Chairman of the Authority, Lord Mogg, in May 2006 and July 2007, and National Grid plc gave assurances to Ofgem in response about the quality and integrity of National Grid plc's regulatory reporting and robustness of its systems of internal controls and external assurance. NGG was therefore aware of the need for accurate regulatory reporting and adequate internal systems. Moreover, the Authority considers NGG's failure to maintain adequate

systems to prevent misreporting or inaccurate reporting to be serious because the misreporting or inaccurate reporting which may result is itself serious;

- 6.4.3. harm to consumers and other market participants after taking into account any compensation paid. The Authority has found that, following actions taken by NGG, there has been no lasting detriment to consumers or other market participants in this case. It notes, however, that in other circumstances the position could have been different;
- 6.4.4. gain made by the licensee. There has been no overall gain to NGG from the misreporting or inaccurate reporting in this case. The Authority also recognises that NGG has incurred costs and has funded both its internal DR4 investigation and the investigation conducted by EY; and
- 6.4.5. the duration of the contraventions. The Authority has taken into account the duration of the contraventions in respect of which it has power to impose a financial penalty, namely from November 2007 to November 2008 for misreporting or inaccurate reporting and until more recently for the contravention in relation to systems, processes and procedures in the mains replacement programme.
- 6.5. In the light of all these factors and the circumstances of this case, the Authority has adopted the starting point for a financial penalty of 1% of NGG's Gas Distribution business in which the misreporting occurred, as described in paragraph 6.2 above.

*Aggravating factors*

- 6.6. The Authority has not found any factors which it considers should lead to an increase in the level of a penalty in this case.

*Mitigating factors*

- 6.7. The Authority has found that the following factors in this case are such as to lead to a reduction in the level of a financial penalty:
  - 6.7.1. prior to November 2008, NGG had taken steps to secure compliance with its licence conditions. In particular, NGG established a Business Conduct Helpline, and it was a telephone call to this Helpline which first drew attention to misreporting in the context of NGG's mains replacement programme. However, the establishment of the Helpline failed to lead to the detection of Misreporting or inaccurate reporting in the context of NGG's mains replacement activities in the financial years 2005/06, 2006/07 and 2007/08. Accordingly, the Authority considers that this factor ought to be given only small weight in determining a reduction in the level of the penalty.
  - 6.7.2. NGG has taken action to remedy the contraventions of its licence conditions in this case:
    - (a) NGG reacted promptly to the allegations of misreporting by establishing an internal inquiry, agreeing to the joint instruction of EY to carry out a third party review, and cooperating with and agreeing to fund that review;
    - (b) in addition, NGG conducted its own review of misreporting or inaccurate reporting under the DR4 procedure;



(c) moreover, NGG has devoted efforts and resource to the implementation of enhancements to its systems, processes and procedures in the mains replacement programme; and

(d) NGG has also made retrospective downward adjustments to its reporting information for years 2005/06, 2006/07 and 2007/08 (submitted to Ofgem on 31 December 2009). However, the Authority has taken these adjustments into account when assessing the degree of harm caused by the infringements in the context of arriving at the proposed general level of penalty, and accordingly gives the adjustments only limited weight as a factor leading to a reduction in a penalty.

- 6.8. The Authority does not consider that the infringements in this case were accidental or inadvertent, and therefore does not propose to reduce the penalty in this case on those grounds.
- 6.9. The Authority takes into account the fact that NGG promptly reported to Ofgem the allegations of misreporting made in the telephone call to NGG's Business Conduct Helpline.
- 6.10. Finally, the Authority also gives significant weight to NGG's cooperation with Ofgem's investigation in this case and its willingness (and agreement) to settle this investigation on the basis of this decision.

## **7. The Authority's decision**

- 7.1. As a result of the matters set out above, the Authority has imposed a penalty of £8,000,000 on NGG in relation to the breaches described above. It considers the penalty to be proportionate to the particular circumstances of this case.
- 7.2. The penalty must be paid by 27 June 2011.

**Gas and Electricity Markets Authority**

**13 May 2011**