The voice of the energy industry

Energy UK Response: Ofgem's Enforcement Guidelines and Sectoral Penalty Statement

4 August 2021

Introduction

Energy UK is the trade association for the energy industry with over 100 members spanning every aspect of the energy sector – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

We represent the diverse nature of the UK's energy industry with our members delivering over 80% of both the UK's power generation and energy supply for the 28 million UK homes as well as businesses. The energy industry invests £13bn annually, delivers £31bn in gross value added on top of the £95bn in economic activity through its supply chain and interaction with other sectors, and supports 738,000 jobs in every corner of the country.

This is a high-level industry view; Energy UK's members may hold different views on particular aspects of the consultation. We would be happy to discuss any of the points made in further detail with Ofgem or any other interested party if this is considered to be beneficial.

Executive Summary

Overall, Energy UK recognises and welcomes Ofgem's stated objective of speeding up and streamlining the enforcement processes and the rationale for undertaking its review of the Enforcement Guidelines and Sectoral Penalty to ensure they provide greater clarity, consistency and transparency. We agree that Ofgem should ensure that they reflect the evolving nature of the energy market and its participants, as well as ensuring they are keeping pace with the changes to the sector and remain fit for purpose.

However, we are concerned that a number of Ofgem's proposals to streamline its processes may not necessarily achieve these stated objectives and we believe that there are a number of areas where further clarification is required to ensure that all parties can have confidence in the proportionality and fairness of the decision-making. Processes should remain transparent for all, and encourage correct behaviour without stifling innovation that is aimed at providing better outcomes for consumers.

We are concerned that Ofgem has not properly explained the reasoning for many of its proposed changes to the Guidelines and Sectoral Policy Statement and has in some cases given no justification for the changes. We are also disappointed that Ofgem has not provided 'tracked changes' versions of the proposed Guidelines and Penalty Statement, which puts respondents to unnecessary effort in comparing the documents – or risks changes going unnoticed.

Feedback on Ofgem's Proposals

Question 1: What is your view on the proposal to remove the middle and late settlement windows, and associated settlement discounts?

Energy UK has some concerns with the impacts that this proposal may have. We note that, as part of the rationale for this reform, Ofgem highlights that no party has yet opted to make use of the middle and late settlement windows since their introduction in 2014 and later revision in 2017. However, just because they have not been used to date, this does not mean that they may not be a useful tool to incentivise settlement in the future. We would welcome confirmation from Ofgem that the offer of such

settlement discounts will be consistently, transparently and proactively applied by Ofgem, rather than something that suppliers would have to raise themselves.

There is also a risk that moving to one settlement window, and not allowing sufficient time for Ofgem and the relevant party to have meaningful discussions around settlement, could perversely reduce the number of cases which are settled. This change will also remove the ability to settle once the full statement of case is provided to the party, as this is only provided under contested cases. We do not see what advantage there is for any party to remove the possibility of settlement once further details have emerged. This would be atypical and inconsistent with any other dispute resolution process, which leave the possibility of settlement open throughout the dispute process – which seems a rational approach and maintains the ability to reduce costs of enforcement throughout the process.

However, perhaps the key issue in this area is not just at what point certain discounts should be applied, but the transparency of what the discount is being applied to. The point of the discounting mechanism is to truly incentivise early settlement, thereby minimising the costs and distraction of a protracted investigation and hearing process for all parties. However, for this to be effective, parties need to be satisfied that a true discount is being provided to the counterfactual. If parties believe that the counterfactual has been inflated (simply to offset the benefit of the discount), the incentive for early settlement is lost. The level of fines determined by the Enforcement Decision Panel once a full process has been concluded are considerably less than proposed by the enforcement team during the settlement process. This ultimately undermines the credibility of the fairness of the outcomes that will be achieved through the settlement process, which in turn disincentivises early settlement and will encourage parties to engage in the full process to ensure that they receive a fair outcome, even if their preference would be to resolve matters more promptly. This effect is likely to be aggravated if Ofgem make changes to the settled process which are perceived to introduce even more bias and reduce independence further.

Question 2: What are your views on the option of allowing the Director responsible for Enforcement to be a decision maker in settlement cases?

While Energy UK acknowledges Ofgem's stated rationale as speeding up the process and sending stronger deterrent signals to the sector, we do not believe that this provides sufficient justification for the proposed change. We are concerned that this will weaken the independence of the decision-making process, and thereby increasing the risk of parties contesting cases in order to obtain a level of independence and fairness in decisions. The creation of the Enforcement Decision Panel was for the very purpose of improving the independence and consistency of Ofgem's enforcement decision-making processes and therefore any proposals that weaken or circumvent these objectives should be avoided. Rather than reducing the burden on Ofgem and investigated parties, it could unintentionally risk increasing it and force parties down alternative appeal routes, such as Judicial Review, if they are left with the impression of an inappropriate outcome as a result of the investigation, decision and penalty all being determined by the same enforcement team – this outcome driven by a process that lacks independence would increase enforcement costs and timescales for all parties.

As noted above in response to Question 1, given the experience of different outcomes resulting from decisions of the EDP compared with decisions of a Director responsible for Enforcement, further changes to the settled process risks giving the perception that the new settled process has been designed to create a biased outcome, or is designed in a way that will lead to a more unfair or unreasonable outcome than would be achieved through a fully contested process. We are concerned that, rather than reduce the amount of fully contested cases, the changes being proposed by Ofgem will have the opposite effect and instead increase the frequency with which parties seek to engage in the full process so that they can be satisfied they will receive a fairer and more independent outcome, even if their preference would be to resolve matters more promptly. We do not see how such a change would be in the interest of consumers, Ofgem or the industry as a whole.

However, If Ofgem continues with this proposal despite these objections and significant concerns, it must provide further justification for the use of a single Director based on the seriousness of a case, or the expertise, and outline thresholds which parties can discuss or appeal (in the spirit of transparency, consistency and fairness).

Question 3: In your view, are there any other steps you think we could take to speed up the settlement process, without undermining the evidence - based nature of our decision making?

Energy UK agrees that that tackling non-compliance early and effectively is important in order to minimise consumer detriment and improve industry practices, but it is equally important for the process to be fair, consistent and proportionate. As previously noted, we believe that forcing parties to make a one-off settlement decision in advance of an initial statement of case and alleged breach(es) is unfair.

We are concerned that Ofgem is signalling a distinct move away from using alternative actions to resolve investigations. Alternative actions should remain a valid option to conclude investigations quickly and resolve any consumer detriment. If that is not the case, it would be helpful for this to be clearly stated in the guidance and the circumstances in which alternative action will be applied documented and clarified.

Energy UK disagrees that alternative actions weaken any deterrent message to the wider market. Ofgem has sought to justify a number of the changes it has proposed on the basis that the current processes, including alternative action, are weakening any deterrent message to the wider market, on the basis that "*alternative action outcomes do not include a formal finding of a breach by the Authority"*. Whilst there is a lack of clarity on the specific procedure to be applied in the course of alternative action (which should be corrected), our understanding is that those participating in the alternative action process are always required to publicly admit a breach. On the conclusion of the alternative action, Ofgem will also issue a press release confirming its finding of a breach.

Whilst we accept that technically this is not a formal finding of a breach, this subtlety will not be visible to external stakeholders or consumers who will not differentiate this from any other finding of a breach by Ofgem. This is apparent from the way the media has reported these informal findings in the past, and indeed how the Ofgem press team has presented them, treating them in the same way as any formal finding. Energy UK therefore strongly disagrees that alternative actions weaken any deterrent message to the wider market, and if this is the rationale for introducing changes further evidence of this must be produced as no compelling evidence of this has been shared to date.

As noted above, we believe it is important that as part of any changes to the guidance, far greater clarity of Ofgem's approach as to when alternative actions would be an appropriate option for it to use should be provided, and for the full alternative action process to be properly defined and documented.

In addition, we would urge Ofgem to provide greater clarity on the benefits of early, open and transparent engagement. The industry fully supports increased openness and transparency between the regulator and suppliers, so that the focus can be on resolving issues promptly and in the best interests of consumers, and so that the learning from this can be widely and quickly shared with other suppliers who can then also implement any necessary actions in response. However, such a response will only become established if suppliers are incentivised to carry out such behaviour.

This could provide really valuable improvements to all consumers, particularly where, through encouraging and rewarding such openness and transparency, industry-wide systems or process issues of which other parties are unaware can be identified. Previously unknown risks or actual customer detriment can then be rapidly rectified for the benefit of all consumers. There is a key difference between suppliers intentionally non-complying, where strong enforcement is needed as a key deterrent, and where a supplier inadvertently becomes aware of a non-compliance and quickly acts to ensure no consumer detriment prevails.

Ofgem will ultimately need to consider which enforcement model it wishes to adopt, but if the objective is to promote the best outcome for consumers we believe that this would be far better served through encouraging suppliers to immediately share such issues, and we believe this would be best achieved by providing the clearest of guidance that in the case of any unintentional non compliances that had been identified by the supplier, Ofgem's enforcement policy would be focussed on ensuring that the issue was promptly fixed and the issue openly shared.

In order to truly achieve the stated aims of a more streamlined enforcement process, we would also urge Ofgem to holistically assess the implication of the length and complexity of the Supply Licence in its current form and the implication of increasing the risk of supplier non-compliance, and extending the

enforcement process due to challenging interpretation of the conditions. The regulatory framework is complicated and numerous rules informing certain operational processes are scattered across the Licence. We would proffer that this has likely been a driving factor in recent cases of supplier non-compliance, particularly those involving a number of different suppliers. We would strongly urge Ofgem to consider streamlining the Licence Conditions and adopt a 'clarity test' for future changes to ensure the regulations are clear, consistent with existing rules and are logically placed within the body of the document.

Question 4: Do you have any comments on the updated guidance on Provisional and Final Orders in section 7 of the guidelines?

Energy UK has no comments, but individual members may provide their views through their responses to the consultation.

Question 5: Is there any other information on Provisional or Final Orders you would find helpful to be in the Guidelines?

Energy UK has no comments, but individual members may provide their views through their responses to the consultation.

Question 6: Do you have any comments on any areas of the revised guidelines?

We do not understand how enabling competition and innovation could be an enforcement objective. Enforcement is about the rules and suppliers' compliance with them, not about encouraging competition.

We fully recognise that the regulatory framework, together with enforcement process, can have a very real impact on both innovation and competition, potentially stifling both if the rules are incorrectly set or applied inappropriately. However, all suppliers also need to have confidence that there is a level playing field when it comes to the rules within which they are required to operate. They have to have confidence that once rules are set, they will be followed by all on the same basis, and the consequences for not doing are the same for all. If the perception arises that certain market participants will be given more favourable treatment (because otherwise they might exit the market and reduce competition), or that certain non-compliances will be ignored (because they arise from attempts at innovation), then the credibility of the enforcement framework will be undermined.

Our members are all fully supportive of innovation and competition, and willing to support the enforcement process being designed to promote these, but this needs to be clarified in clear and unambiguous terms within the guidance so that there is a level playing field for all, and so that everybody understands how the enforcement regime and this extremely important objective will interact. As part of this transparency Ofgem should provide greater clarity on how goodwill is calculated, as from the publicly available information on this it is challenging to determine how this has been consistently calculated for different parties.

An objective of addressing non-compliance that was detrimental to competition and innovation may be more appropriate for Ofgem's enforcement objective.

Question 7: What are your views on the changes to the Sectoral Penalty Statement?

Ofgem's proposals to move to more principles-based wording on its approach in the Penalty Statement, away from the quite detailed wording currently, is seemingly at odds with the stated objective of 'providing greater clarity, consistency and transparency'. We are concerned that it will give suppliers less clarity on what will be taken into consideration when establishing penalty levels and risks undermining parties' confidence that consistent, fair and proportionate approaches will be taken in every case.

In addition, we are concerned that self-reporting will no longer be a mitigating factor in penalty decisions given that it would itself be non-compliance. It is important for parties to have confidence in the enforcement and investigation process, and that they will be treated fairly and proportionately. We are

concerned that if there is not this confidence in being treated fairly and proportionately when self-reporting, then this will disincentivise self-reporting.

Calculation of Supplier Gain and Consumer Detriment

Ofgem is proposing a significant change to its approach to sanctions for regulated parties, namely only calculating the detriment to consumers as a result of the relevant breach(es) where it is proportionate, reasonable and practicable to do so. This is, as with many of Ofgem's proposed changes, justified on the basis that it is complex and time-consuming to do so. However, this is not the experience of our members who have provided such calculations to Ofgem within extremely short timescales. Therefore, we would urge Ofgem not to remove the clear and robust framework from the Penalty Statement on when and how to calculate detriment and gain, as well as the elements of the calculation itself.

We do not see how Ofgem can follow a proper and legitimate enforcement process aimed at assessing consumer detriment when it is not specifically calculated, and is instead considered generally as part of its assessment of seriousness (Step 2 of the calculation of the financial penalty or consumer redress). This is fundamental to fair and legitimate process, that ultimately will result in a potentially significant payment obligation being placed on a supplier. Before such a change can be implemented Ofgem needs to clearly explain how it intends to assess and weigh proportionality and practicality when considering whether or not to actually calculate consumer detriment, and what opportunity suppliers will have to challenge Ofgem's views. There is also a lack of clarity on how Ofgem will determine penalty amounts where no detriment is calculated.

We are also concerned that this approach is being designed to limit regulated parties' ability to make representations on Ofgem's calculations of the financial penalty, which is a material concern given the potential implications this could have on a fair, proportionate and accurate outcome. In practice at present, parties are typically given the opportunity to make representations on Ofgem's assessment of consumer detriment and supplier gain. If Ofgem decides that it is not proportionate, reasonable and practicable to calculate consumer detriment (or indeed supplier gain), parties should be able to make representations on these factors and how they should be considered by Ofgem as part of its assessment of seriousness. Ofgem should also be required to justify its decision whether or not to calculate consumer detriment and/or supplier gain, and include its assessment of these factors as part of its assessment of seriousness. Otherwise, the process would not be sufficiently transparent.

While we concede that Ofgem's proposed change of approach in this instance will result in less time and resource being spent on calculating supplier gain and consumer detriment, speed of process cannot be a justification for avoiding a proper process. We also note that Ofgem (as with other changes) does not appear to have considered whether they will result in more satisfactory outcomes for industry and, more importantly, consumers. There is a risk that dispensing with a specific calculation of supplier gain and, in particular, consumer detriment, will result in consumer detriment being included in Ofgem's assessment of seriousness in circumstances where a precise calculation would have resulted in little or no consumer detriment actually being assessed. This is particularly the case if regulated parties are not given the opportunity to make representations on consumer detriment as part of Ofgem's assessment of seriousness.

Unjustified Changes

Energy UK is concerned that a number of changes have been made to the guidance without being explicitly referenced in the consultation itself:

- Ofgem is proposing to remove the following from paragraph 5.1 of the Statement: "*The amount of any financial penalty must be reasonable in all the circumstances of the case*". We ask that Ofgem confirm in the Statement whether they intend to continue to only impose financial penalties that are reasonable in all the circumstances, and if not, to explain why.
- Ofgem is also proposing to remove the following from paragraph 8.3 of the Statement: "*The Authority will not normally require regulated persons to pay compensation for stress or anxiety caused to one or more consumers as a result of a contravention*". However, Ofgem has not provided any explanation or justification for this change.

These are potentially significant reforms which Ofgem have not referenced in the consultation document. We would welcome clarification on the rationale behind these changes, and the impact that Ofgem expects they will have.

For further information or to discuss our response in more detail please contact Steve Kirkwood on 0207 747 2931 or Steve.Kirkwood@Energy-UK.org.uk.