
Memorandum

To	David Hosker	United Utilities Plc	15 May 2007
			Our reference CJCW
From	Christopher Wright	Writer's direct line 020 7090 4425 christopher.wright@slaughterandmay.com	

United Utilities Water Proposed Penalty – Representations of United Utilities Water (“UUW”)

1. We refer to the notice issued to UUW by Ofwat under section 22(A)4 of the Water Industry Act 1991 (as amended) (the “WIA91”), dated 17 April 2007 (the “Notice”). The Notice proposes the imposition of a financial penalty on UUW for an alleged breach of Condition F of its appointment as a water and sewerage undertaker. The Notice proposes a penalty of 0.7% of UUW's turnover in the 2005-6 Charging Year, which equates to a financial penalty of £8.5m.
2. We do not repeat the exchanges that have already taken place in relation to UUW's contention, with which we agree, that Ofwat has failed adequately to demonstrate that UUW has contravened the terms of Condition F of its appointment.¹
3. Nonetheless, even if it were accepted (which we do not) that such contravention had taken place, the Notice is defective in three material respects:
 - (A) it fails to demonstrate that a penalty is appropriate;
 - (B) it fails properly to apply the statement of policy in relation to the imposition of financial penalties (the “Policy”), to which Ofwat is required by statute to have regard in making decisions to impose penalties and in determining their amount ; and
 - (C) it fails to provide proper reasoning for the level of penalty proposed.
4. We recommend that UUW makes representations in these terms. UUW should reserve the right to make further representations in any appeal under section 22(E) of the Act, and to rely in any such proceedings on its previous representations and on all relevant documents.

¹ Ofwat contends that it is not required to demonstrate the existence of cross-subsidy in order to establish a breach of Condition F6.8; it considers it sufficient to show that a company has not market tested. However, Condition F6.8 states that a payment shall not be paid to associated companies: “*which exceeds- (i) such prices in respect of the service in question which the Appointee has ascertained by market testing ...*” [emphasis added]. Ofwat has not shown that UUW paid such a price to its relevant associates.

A. Failure to demonstrate that a penalty is appropriate

5. The Policy sets out certain factors which Ofwat is required to consider when deciding whether it is appropriate to impose a penalty:

“3.2 When considering whether to impose a penalty, a penalty is more likely where:

- the contravention or failure has damaged the interests of the customers or other market participants or damaged the environment; or
- applying a penalty would be likely to create an incentive to comply and deter future contraventions or failures.” [Original emphasis.]

6. Ofwat contends that, in stating that it is only “more likely” that a penalty would be imposed in these circumstances, the Policy does not require these tests to be met in order for Ofwat to decide that a penalty is appropriate. This construction ignores the preamble “When considering whether to impose a penalty ...”. It also ignores the fact that no other criteria are cited in the Policy. The purpose of the policy is to show the regulated community how Ofwat will exercise its fining powers. If it is possible for Ofwat to decide on other, unstated, grounds that a penalty is appropriate, what is the point of the extant Policy?

Harm to customers

7. The Notice asserts in any event that UUW’s alleged contravention has caused harm to customers.² UUW has argued that any harm to customers is entirely *de minimis* since Ofwat is able in price reviews to adjust for any potential cross-subsidies. Ofwat now concedes that the alleged contravention has had “*no direct impact on the prices paid by water customers.*”³ However, Ofwat nonetheless makes the contradictory statement that this is “*insufficient to protect customers from having to pay higher prices*”. It is wholly unclear, therefore, whether the fine has a restitutorial aim or some other motivation.

8. In the absence of any identified harm to customers, Ofwat then relies upon “*the tendency of the contravention to undermine the regulatory regime to the detriment of customers.*”⁴ This statement makes no attempt to specify how such a “tendency” undermines the regime or what is the resulting detriment to customers. Such a vague analysis clearly does not meet the minimum standard of reasoning demanded by public law, and is an insufficient basis to justify the imposition of a penalty.

Other market participants

9. Ofwat also seeks to justify the imposition of a penalty on the basis that the interests of other market participants have been harmed. It provides, however, only cursory consideration of this issue too, stating that there was no more than “a possibility” that UUW’s trading

² Page 90 of the Notice.

³ Page 98 of the Notice.

⁴ Page 98 of the Notice.

arrangement caused damage to other market participants who could have provided the services to U UW that it obtained from its associates.⁵ Ofwat provides no evidence for this assertion, including as to whether such market participants would have been in a position to provide the services and whether it would have been profitable for them to do so (presumably Ofwat would assume at a lower price); or any other evidence. This part of the Notice is clearly an afterthought (it was not referred to in the draft Section 22(A) Notice) and does not provide any meaningful justification for the imposition of a financial penalty.

Incentive

10. The Policy states that a penalty is also “more likely” to be imposed where it would be likely to create an incentive to comply and deter future contraventions or failures. Ofwat considers that the imposition of a penalty in this case will provide such an incentive. Ofwat rejects U UW’s contention that its section 19 undertaking already provides a sufficient incentive on the basis that it has not provided evidence to support its assertion.⁶ However, it is not incumbent upon U UW to prove that a section 19 undertaking provides sufficient incentive. It is for Ofwat to demonstrate that a section 19 undertaking is not a sufficient deterrent and that the imposition of a penalty will provide the necessary incentive to compliance. In doing so, Ofwat could reasonably be expected to take account of those aspects of the enforcement regime which provide such an incentive, including the potential legal and economic effects of non-compliance on the appointee. It does not, however, do so – preferring merely to assert that *“the imposition of a penalty in this case would be likely to create a valuable incentive for compliance and to deter future contraventions of this kind.”*
11. Such cursory analysis is insufficient to satisfy the requirement for proper consideration of the relevant factors set out in the Policy.

Conclusion on Ofwat’s failure to demonstrate that a penalty is appropriate

12. There are fundamental flaws in Ofwat’s assessment of the relevant factors prescribed by the Policy, which vitiate its reliance upon these factors in its decision to impose a penalty upon U UW. Without any substantive basis of reasoning in the application of these factors, Ofwat is left with little to justify the imposition of a penalty other than that the failure to market test was within U UW’s control and that this should have been apparent to U UW. It is clear from the terms of the Policy that these considerations alone are insufficient to justify the imposition of a penalty or that, if they were (which we do not accept), the penalty is wholly disproportionate in relation to them.

Failure properly to apply the Policy in setting the level of fine

13. The Policy states that Ofwat should undertake the following steps when setting a penalty:
 - Consider the appropriate level of the penalty with reference to relevant factors including:
 - the seriousness and duration of the contravention or failure;

⁵ Page 93 of the Notice.

⁶ Page 93 of the Notice.

- the degree of nuisance, harm or increased cost incurred by customers, other market participants or the environment;
 - any gain (financially or otherwise) made by the undertaker or licensee as a result of the contravention or failure;
 - precedents set under equivalent provisions for other utilities and public services; and
 - the level of any other penalty already or potentially imposed through other regulatory means in relation to the same contravention or failure;
- Consider any aggravating factors and adjust the penalty accordingly;
 - Consider any mitigating factors and adjust the penalty accordingly; and
 - Ensure that the penalty does not constitute more than 10% of turnover.
14. However, instead of considering the relevant factors in order to set the starting point, Ofwat merely sets a starting point based on a sliding scale of 0 – 10%. In doing so, Ofwat fails to appreciate that the 10% maximum acts only as a cross-check to ensure the fine is within the statutory maximum, *once a starting point has been properly established* and adjustments made for aggravating and mitigating factors. It does not form part of a sliding scale to be used to establish the starting point.
15. In addition, no reasoning is given as to the basis for choosing 0.8% of turnover as the starting point
16. Our advice to UJW is that this departure from policy is ultra vires section 22B of the Act, and hence unlawful. Those who are regulated by Ofwat should be able to take comfort from the protection granted against arbitrary financial sanctions through the existence of a Policy with statutory force. They are entitled to assume, consistently with the statutory regime, that Ofwat will not seek to calculate and impose fines in a manner which ignores the Policy in a crucial respect.
17. Ofwat will no doubt say that its duty is only to “have regard” to its Policy, not to apply it in all circumstances. However, we would submit that the development and publication of a Policy in pursuit of a statutory requirement creates a legitimate expectation on the part of the regulated community that it will be applied wherever possible. We say this for four reasons.
- Unlike the position in some other public law contexts, the statutory policy to which Ofwat is to have regard has been devised by Ofwat *itself* and not imposed upon it by a third party.
 - The policy must accordingly be taken to represent Ofwat’s view as to how its statutory duties and functions will be carried out. Indeed, when Standing Committee A considered the exactly equivalent provision in the course of the passage of the Utilities Act 2000, the Minister (Mrs Liddell) said in answer to a question:

“The authority will have to consult on its policy statement, which will always be in the public domain, and revisions of the policy statement will require further consultation. The policy statement itself and the consultation that will surround it will provide an important element of certainty for companies and a means whereby the authority’s

activities are made transparent and constrained by the reasonableness provided for under the clause.” [Emphasis added.]

- An important purpose of the statement of policy is therefore to give fair warning to appointees of the approach of Ofwat, as well as to structure Ofwat’s approach to its power to penalise. It if can step outside the Policy at will, that purpose is frustrated.
- Ofwat has not suggested that the case gives rise to exceptional circumstances such that the Policy cannot be properly applied: indeed it has sought to apply it in this case but departed from it in a crucial respect. Ofwat should therefore give cogent reasons for such departure from its Policy.⁷ It has given none.

C. Lack of adequate reasoning to establish the level of the proposed penalty

18. Although Ofwat goes on to recite the relevant factors prescribed by the Notice, there is no, or no adequate, reasoning to support Ofwat’s conclusions on these factors. In the exercise of its power under Section 22(A) of the Act to impose a “reasonable” financial penalty, it is incumbent on Ofwat under this statutory framework to give reasons for the basis on which it proposes to impose a penalty.⁸

Lack of adequate reasoning in support of Ofwat’s conclusions

19. The Policy states that Ofwat should consider the following factors when deciding on the level of the penalty:
- the seriousness and duration of the contravention;
 - the degree of harm to customers, other market participants and the environment;
 - any gain to the undertaker;
 - precedents; and
 - the level of any other penalty already imposed for the same failure.

⁷ *Gransden & Co. Ltd. v. Secretary of State for the Environment* (1987) 54 P. & C.R. 86 as per Woolf J at page 94: “...the fact that a body has to have regard to the policy does not mean that it needs necessarily to follow the policy. However, if it is going to depart from the policy, it must give reasons for not doing so in order that the recipient of its decision will know why the decision is being made as an exception to the policy and the grounds upon which the decision is taken.”; see also: *R (Khatun) v. London Borough of Newham* [2004] 3 WLR 417 at para. 47 (p. 437) and *Argos Limited and JJB Sports plc v. Office of Fair Trading* [2006] EWCA Civ 1318 at para. 161.

⁸ In addition, as a matter of public law such a duty may be implied: *R v Secretary of State for the Home Department, ex parte Doody* [1994] 1 AC 531 at p. 564; *R v Civil Service Appeal Board, ex parte Cunningham* [1991] 4 All ER 310; *Lonhro plc v Secretary of State for Trade and Industry* [1989] 2 All ER 609 at 620 (Lord Keith): ‘The only significance of the absence of reasons is that if all other known facts and circumstances appear to point overwhelmingly in favour of a different decision, the decision-maker, who has given no reasons cannot complain if the court draws the inference that he had no rational reason for his decision.’

20. Ofwat considers these factors in only a cursory manner. Further, its consideration lacks any meaningful link with the level of penalty. Ofwat goes no further than to repeat the points it made when considering whether to impose a penalty at all.⁹ Ofwat does not make any attempt to connect the alleged failures to any resulting penalty figure.
21. Similarly, with regard to aggravating and mitigating factors, as noted above, although Ofwat lists considerations to be taken into account under each head it makes no attempt to link these considerations to the increase and reduction in the penalty that it proposes.¹⁰ Ofwat merely gives an overall percentage increase and decrease at the end of each section. There is nothing to suggest why it chose an increase of 0.2% with regard to aggravating factors and a decrease of 0.3% with regard to mitigating factors

Precedents

22. Finally, Ofwat seeks to justify the starting amount of 0.8% of turnover by “having had regard to the penalties levied by other regulators and other relevant precedents.”¹¹ Indeed, given the absence of any meaningful reasoning in relation to the other factors set out in the Notice, Ofwat’s justification for the penalty in fact rests *entirely* on these precedents. Moreover, there is not only no reasoning to support the above statement, but the facts actually suggest the opposite conclusion to that drawn by Ofwat.

23. Ofwat noted earlier in the Notice that it had:

“not identified any precedents from other utilities or public services which appear to be of particular relevance to the contravention we are concerned with in the present case...However, in arriving at a proposed penalty in this case, Ofwat has been mindful of the generality of the penalties imposed by other regulators in respect of contraventions and failures of various kinds, and is of the opinion that the penalty proposed in the present case is reasonable having regard to those other penalties.”¹²

24. All that reliance on such precedents can ever show is that the penalty is somewhere within a range, and not that the relevant cases are analogous. Annex 1 contains descriptions of a number of precedents for the imposition of penalties by regulators. These examples provide no assistance in explaining why a starting point of 0.8% of turnover or an end point of 0.7% of turnover was chosen. Many of the precedents in Annex 1 indicate a much lower level of penalty even for quite serious breaches. In reality, however, the divergence provides no indication as to what penalty should be imposed. Ofwat’s reference to past precedents is, therefore, both unsubstantiated and unsubstantiable.

⁹ This can be seen with reference to Ofwat’s analysis under the heading “The degree of nuisance, harm or increased cost incurred by customers, other market participants or the environment.” In this section from page 105 to page 107, the language is an exact replica of the language from pages 91 to 92 in the “Damage to the interests of customers” section of Ofwat’s report where it considers whether or not it should impose a penalty.

¹⁰ Pages 110 to 113 of the Notice.

¹¹ Page 110 of the Notice.

¹² Page 108 of the Notice.

Conclusion on the lack of reasoning

25. Although Ofwat mentions the relevant factors set out in the Policy, it did not have regard to these considerations in any meaningful sense. Ofwat has not provided adequate reasons, nor properly applied the terms of the Policy in reaching its decision to impose a penalty of £8.5 million on UUW, which as a result is entirely arbitrary and disproportionate. On the basis of any proper analysis and proper application of the Policy, no penalty should be imposed. If it were accepted (which it is not) that a penalty should be imposed it is clear in any event that it should be significantly lower than £8.5 million.

Overall conclusions

26. In its proposal for a financial penalty, Ofwat:
- has erred in law by disregarding its Policy in setting a starting point for the fine; and
 - has advanced no substantive reasoning for the level of fine proposed.

Against the analysis set out in this note, Ofwat's proposed fine is excessive and wholly disproportionate.

Annex 1

Penalties by Regulators

- Ofgem imposed a penalty of 0.02% of turnover on British Gas Trading Limited (BGT) when it breached a condition of its Licence and failed to comply with its Master Registration Agreement. In this case the penalty was much lower than UUW's penalty despite the fact that 2,900 customers were affected and BGT had refused to compensate them;
- Ofgem imposed a penalty of 0.02% of turnover on Powergen Retail Limited for breach of a Licence condition when it blocked non-domestic supplier transfers. Again the penalty was much lower than that imposed on UUW despite the fact that 7,300 customers were affected;
- Ofgem imposed a penalty of 0.02% of turnover on Npower Yorkshire Supply Limited for breach of a licence condition and failure to comply with the Master Registration Agreement. Again 908 customers were affected and these customers were not compensated. Competitors also incurred costs in wasted sales activity;
- Other penalties imposed by Ofgem include: £2 million on London Electricity (now EdF) in 2002 for mis-selling; £200,000 on British Gas Trading in 2003 for making incorrect objections to customers switching to another gas or electricity supplier; £200,000 on both Npower and Scottish Power in 2004 for unfairly preventing 9,000 customers from switching to new gas and electricity suppliers; £700,000 on Powergen in 2004 for unfairly preventing more than 20,000 customers from switching to new gas and electricity suppliers and £1 million on Transco in 2004 for failure to meet its gas connection obligations where a wide range of customers were affected. In each of these cases although the relevant turnover is not known it is clear that the above penalties constitute a very small percentage of relevant turnover. In most cases the penalty is therefore much lower than that imposed on UUW;
- Ofcom imposed a penalty of 5% of turnover or £250,000 whichever was the greatest, on Playboy TV/Benelux Limited for breach of the Programme Code. This was for the repeated breach of an absolute prohibition;
- Ofcom imposed a penalty of 5% of turnover or £250,000 whichever was the greatest, on Galaxy Radio Manchester for breach of the Standards Code. This involved the clear breach of a provision to protect the younger audience.
- Other penalties imposed by Ofcom include: £100,000 on Gamecase UK for serious breaches of the Broadcasting Code (its licence for You TV 2 was later revoked in 2001 for failure to pay this penalty); £175,000 in 2006 on Television Concepts Limited for serious breach of the British Committee of Advertising Practice Television Advertising Standards Code and £450,000 on Chase-It TV in 2004 for breaches of Ofcom's Advertising Standards Code (its licence was later revoked for failure to pay). In addition a number of smaller penalties of under £50,000 have been imposed including penalties pursuant to section 130 of the Communications Act 2003 for activities such as making excessive amounts of silent and abandoned calls (Space Kitchens, Bracken Bay Kitchens, Carphone Warehouse and Toucan) and the persistent misuse of the electronic communications network (IRT).

- Postcomm imposed a penalty of £9.62 million on Royal Mail in August 2006 for breach of licence conditions relating to its duty to safeguard the integrity of the mail (this penalty is under appeal to the Court of Appeal).
- Postcomm imposed a penalty of £1 million on Royal Mail in July 2006 for failure to take adequate steps to ensure that it did not gain a commercial advantage over competitors in the “access to the last mile” market (this penalty is under appeal to the High Court).