

**Notice of Ofwat's proposed variation to its proposal to impose a penalty on Severn
Trent Water Limited**

This document constitutes a Notice given by the Water Services Regulation Authority ("Ofwat") under and in accordance with section 22A(5) of the Water Industry Act 1991 (as amended) ("WIA91").

WHEREAS:

- i) Ofwat has a power under section 22A(1) WIA91, subject to certain conditions being met, to impose a penalty on a water and/or sewerage undertaker which Ofwat is satisfied has failed or is failing to achieve any standard of performance prescribed under section 38(2) WIA91 or 95(2) WIA91;
- ii) By a Notice in writing dated 8 June 2006, Ofwat gave notice, under and in accordance with section 22A(4) WIA91, of its proposal to impose a penalty on Severn Trent Water Limited ("Severn Trent") and the various matters of which notice must be given under section 22A(4) WIA91; a copy of that Notice (the "Section 22A(4) Notice") is annexed to this Notice (see Annex 1);
- iii) In the Section 22A(4) Notice, Ofwat set out the following (amongst other things):
 - (a) that Ofwat was satisfied that Severn Trent had failed to achieve standards of performance prescribed under sections 38(2) and 95(2) WIA91, namely the standards in the Water Supply and Sewerage Services (Customer Service Standards) Regulations 1989 (as amended) (the "GSS Regulations");
 - (b) that the proposal to impose a penalty was in respect of Severn Trent's failure to achieve standards of performance prescribed under sections 38(2) and 95(2) WIA91, namely the GSS Regulations, at all material times between 9 June 2005 and 8 June 2006;
 - (c) the omissions which, in the opinion of Ofwat, constituted the failures in question which justified the imposition of a penalty;
 - (d) Ofwat required Severn Trent to provide further information as to the extent of the failures to allow Ofwat to quantify fully the amount of the penalty proposed to be imposed, which was at that time set at a nominal sum of £1;
 - (e) that it was likely that Ofwat would vary the proposal stated in the Section 22A(4) Notice once Severn Trent had provided information as to the full extent of the failures;

- iv) On 7 June 2006 Ofwat served a Notice on Severn Trent under section 203(2) WIA91 ("the Section 203 Notice") requiring Severn Trent to produce certain documents and to furnish certain information to Ofwat concerning Severn Trent's misreporting of regulatory information in respect of customer services including compliance with the GSS Regulations. Severn Trent responded to the Section 203 Notice and cross-referred to that response in responding to the Section 22A(4) Notice;
- v) Severn Trent has provided Ofwat with further information as to the extent of the failures to achieve the standards of performance prescribed under the GSS Regulations. Ofwat is now better able to quantify the amount of the penalty it proposes to impose on Severn Trent in respect of those failures; and therefore proposes to vary the proposal stated in the Section 22A(4) Notice;
- vi) Section 22A(5) WIA91 provides that before varying any proposal stated in a Notice given under section 22A(4), Ofwat shall give notice:
 - (a) Setting out the proposed variation and the reasons for it; and
 - (b) Specifying a period (not being less than twenty-one days from the date of publication of the Notice) within which representations or objections with respect to the proposed variation may be made;and shall consider any representations or objections which are duly made and not withdrawn;
- vii) Ofwat has chosen to set out in full in the attached schedule the matters that Ofwat is required to set out under section 22A(4) WIA91; and
- viii) By a separate Notice dated 7 April 2008, Ofwat has given notice under and in accordance with section 22A(4) WIA91 of its proposal to impose a penalty and the amount of the penalty proposed to be imposed in respect of Severn Trent's contraventions of Condition J and/or Condition M of its Conditions of Appointment (the "Condition J/M Notice"). This Notice of proposed variation is without prejudice to the proposal contained in that separate Notice.

NOW THEREFORE, OFWAT HEREBY GIVES NOTICE, UNDER AND IN ACCORDANCE WITH SECTION 22A(5) WIA91, TO ALL WHOM IT MAY CONCERN THAT:

- i) For the reasons set out in the attached schedule, Ofwat proposes to vary the proposal to impose a penalty stated under section 22A(4), as set out in the Section 22A(4) Notice, in respect of Severn Trent's failure to achieve standards of performance prescribed under section 38(2) WIA91 or 95(2) WIA91 by setting out more fully the extent of the failures and varying the amount of the proposed penalty now that Severn Trent has provided Ofwat with further information revealing more fully the extent of the failures;
- ii) the amount of the penalty which Ofwat is now proposing to impose is 0.1% of Severn Trent's applicable turnover in 2005-06. This amounts to £1.1 million.
- iii) any representations or objections with respect to this variation of the proposal to impose a penalty should be made to Ofwat in writing no later than 5 pm on 6 May 2008 and in accordance with the instructions set out in section 5 of the attached Schedule.

Keith Mason

Director of Regulatory Finance and Competition

For and on behalf of the Water Services Regulation Authority

Dated this day, 07 April 2008

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1. Introduction and summary

1. Severn Trent Water Limited ("Severn Trent") is an appointed water and sewerage undertaker and as such, is required to meet minimum standards of performance as set out under GSS Regulations.
2. Where an undertaker fails to meet the minimum standards of performance prescribed under the GSS Regulations, customers will have received service which is below an acceptable level. Ofwat therefore regards a water undertaker's failure to meet the minimum prescribed standards as a serious matter, particularly where, as in this case, the company's customers have suffered directly.
3. Ofwat is satisfied that Severn Trent failed to meet the prescribed standards. During the period from 9 June 2005 to 8 June 2006 Severn Trent failed to meet the minimum standards on over 10,000 occasions. Ofwat is proposing to impose a penalty on Severn Trent in respect of its failures.
4. Ofwat considers a penalty to be appropriate in order to provide an incentive on Thames Water and other undertakers to ensure that they adequately monitor and control performance against the standards prescribed under the GSS Regulations and to ensure that they make necessary GSS payments at the time failures occur.
5. On 8 June 2006, Ofwat published a Notice under section 22A(4) WIA91 (the "Section 22A(4) Notice"), setting out its proposal to impose a penalty on Severn Trent for its failures to meet minimum standards of service. Ofwat is now varying the proposal contained in that Notice.
6. No other penalty has been imposed or is proposed in relation to Severn Trent's failure to meet the prescribed standards under GSS Regulations, although Ofwat has also issued the Condition J/M Notice on 7 April 2008. Ofwat has drawn a careful distinction between the failures to meet the appropriate GSS standards and the deliberate misreporting in relation to Conditions J and/or M. It is only the failures to meet standards prescribed under the GSS Regulations which are considered when assessing the appropriateness of a penalty and its amount in this Notice.
7. This schedule sets out the acts and omissions which, in Ofwat's opinion constitute the failures in question and the other facts which, in Ofwat's opinion, justify the

proposed imposition of the penalty and its amount.

8. The total amount of the penalty Ofwat is now proposing to impose on Severn Trent is 0.1% of Severn Trent's applicable turnover for the business year in 2005-06. This amounts to £1.1 million.

2. The relevant regulatory provisions

2.1 Ofwat

9. On 1 April 2006, pursuant to section 34 of the Water Act 2003 (“WA03”) and article 4 of the Water Act 2003 (Commencement No 5, Transitional Provisions and Savings) Order 2005, SI 2005 No 2714, a body corporate known as the Water Services Regulation Authority replaced the officer known as the Director General of Water Services (the “Director”). On the same day the functions of the Director were transferred to the Water Services Regulation Authority under section 36 of the WA03 and the Water Services Regulation Authority Transfer Scheme 2006.
10. Pursuant to WA03, Schedule 3, anything done by the Director for the purpose of or in connection with any of his functions and which was in effect immediately before the transfer is treated as if done by the Water Services Regulation Authority. The transfer of the functions does not affect the validity of anything done by the Director before the transfer took place. The Water Services Regulation Authority is substituted for the Director in any document relating to anything transferred.
11. In this Schedule, “Ofwat” is used to mean both the Water Services Regulation Authority from 1 April 2006 and the Director prior to 1 April 2006.
12. Ofwat is the economic regulator for the water and sewerage industry in England and Wales. Ofwat must exercise and perform most of its powers and duties, in the manner in which it considers is best calculated:
 - (i) to further the consumer objective (namely to protect the interests of consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services);
 - (ii) to secure that the functions of a water undertaker and of a sewerage undertaker are properly carried out as respects every area of England and Wales; and
 - (iii) to secure that undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions.

2.2 Severn Trent's appointment as an undertaker

13. By an Instrument of Appointment dated August 1989 ("Severn Trent's Instrument of Appointment"), the Secretary of State for the Environment appointed Severn Trent as a water and sewerage undertaker under sections 11 and 14 of the Water Act 1989 (now sections 6, 7, 11 and 12 WIA91).

2.3 Penalties

14. Under section 22A(1) WIA91 Ofwat may impose on an undertaker a penalty of such amount as is reasonable in all the circumstances of the case where, amongst other things, it is satisfied that the undertaker has failed or is failing to achieve any standard of performance prescribed under section 38(2) or 95(2) WIA91.
15. Section 22A(9) WIA91 provides that penalties imposed under section 22A WIA91 must be paid into the Consolidated Fund.
16. Pursuant to section 22A(10) WIA91, the power to impose a penalty under section 22A is not exercisable in respect of any contravention or failure before the commencement of that section (on 1 April 2005, pursuant to the Water Act 2003 (Commencement No. 4, Transitional Provisions and Savings) Order 2005, SI 2005 No. 968, Article 2(i)). Further, pursuant to section 22C(1) WIA91, in a case where no final or provisional order has been made in relation to the contravention or failure in question (as is the situation in the present case), Ofwat may not impose a penalty in respect of the contravention or failure later than the end of the period of twelve months from the time of the contravention or failure, unless before the end of that period:
 - (i) a Notice under section 22A(4) WIA91 relating to the penalty is served on the undertaker under section 22A(8) WIA91; or
 - (ii) a Notice relating to the contravention or failure is served on the undertaker under section 203(2) WIA91.
17. In the present case, a relevant Notice under section 22A(4) WIA91 was served by Ofwat on Severn Trent on 8 June 2006. Accordingly, Ofwat cannot impose a penalty on Severn Trent in respect of any failure to achieve the prescribed standards that occurred prior to 8 June 2005. In the Section 22A(4) Notice, however, Ofwat indicated that it proposed only to impose a penalty in respect of the period

commencing on 9 June 2005. In the circumstances, and without prejudice to the proper construction of section 22C(1) WIA91, Ofwat proposes only to impose a penalty in respect of the period from 9 June 2005 to 8 June 2006.

18. In accordance with section 22B WIA91, Ofwat has prepared (jointly with the Secretary of State for the Environment, Food and Rural Affairs and the National Assembly for Wales) and published on 17 March 2005 a Statement of Policy with respect to the imposition of penalties and the determination of their amount (the “Statement of Policy”). Ofwat must have regard to the Statement of Policy in deciding whether to impose a penalty, and in determining the amount of any penalty. The Statement of Policy is available at Annex 2 to this Schedule, and is the version of the policy that was in force at all material times.
19. Pursuant to section 22A(11) WIA91, no penalty imposed by Ofwat under section 22A may exceed 10% of the turnover of the company, determined in accordance with the Water Industry (Determination of Turnover for Penalties) Order 2005 (SI 2005 No. 477). Article 3 of that Order provides (so far as material) that for the purposes of section 22A(11) WIA91, the turnover of a company shall be the applicable turnover for the preceding business year (i.e. the last business year preceding the date on which Ofwat gives notice under section 22A(4) WIA91).
20. By article 2(2) (so far as material), “applicable turnover” means “... the amounts, determined in conformity with normal accounting practice in the United Kingdom, which are derived by a company from the provision of goods and services in the course of the company’s regulated activities in respect of which the penalty is imposed ...”
21. By Article 2(1), “regulated activities” means (so far as material) –
 - “(a) in the case of a company holding an appointment as a water undertaker, its functions as a water undertaker;*
 - “(b) in the case of a company holding an appointment as a sewerage undertaker, its functions as a sewerage undertaker;”*
22. Ofwat considers that Severn Trent's failures to meet the standards of performance prescribed under the GSS Regulations relate to Severn Trent’s regulated activities as

both a water undertaker and a sewerage undertaker. In the circumstances, the applicable turnover for the purposes of Article 3 of SI 2005/477 is Severn Trent's turnover derived from its functions as both a water undertaker and a sewerage undertaker.

23. Severn Trent's applicable turnover for the last business year preceding the date of the Section 22A(4) Notice (i.e. the 2005-06 reporting year) was £1,127.5million. Accordingly, the maximum possible penalty for Severn Trent's contravention in this case is 10 % of £1,127.5million, i.e. £112.8million.
24. For the avoidance of doubt, Ofwat is satisfied, for the purpose of section 22A(13) WIA91, that the Competition Act 1998 is not the most appropriate way of proceeding.

2.4 The GSS Regulations

25. Under section 22A(4) WIA91, Ofwat is required to set out the standard(s) of performance which the undertaker has failed to achieve.
26. Section 38 WIA91 provides (so far as presently material):

“(2) The Secretary of State may, in accordance with section 39 below, by regulations prescribe such standards of performance in connection with the provision of supplies of water as, in his opinion, ought to be achieved in individual cases.

(3) Regulations under subsection (2) above may provide that if a water undertaker fails to meet a prescribed standard it shall pay such amount as may be prescribed to any person who is affected by the failure and is of a prescribed description.”

27. Section 95 WIA91 provides (so far as presently material):

“(2) The Secretary of State may, in accordance with section 96 below, by regulations prescribe such standards of performance in connection with the provision of sewerage services as, in his opinion, ought to be achieved in individual cases.

(3) Regulations under subsection (2) above may provide that, if a sewerage undertaker fails to meet a prescribed standard, it shall pay such amount as may be prescribed to any person who is affected by the failure and is of a prescribed

description.”

28. The Regulations made pursuant to those powers are the Water Supply and Sewerage Services (Customer Service Standards) Regulations 1989, SI 1989/1383, as amended by SI 1993/500, SI 1996/3065, SI 2000/2301 and SI 2005/2035¹. Those Regulations are referred to as the Guaranteed Standards Scheme Regulations (the “GSS Regulations”) The GSS Regulations prescribe standards of performance in connection with the provision of water and sewerage services under sections 38(2) and 95(2) WIA91 (the “prescribed standards”) and provide for payments to be made to affected persons if a water or sewerage undertaker fails to meet the prescribed standards in individual cases (under sections 38(3) and 95(3) WIA91).
29. The prescribed standards relate to:
- making and keeping of appointments – including giving notice of the appointment to the customer and offering a time slot for the appointment (Regulation 3);
 - responding within a certain timeframe with a substantive reply to queries about the correctness of an account and requests about changing payment arrangements (Regulation 4);
 - responding within a certain timeframe with a substantive reply to written complaints from customers in connection with the supply of water or the provision of sewerage services (Regulation 5);
 - interruptions to supply – including giving adequate notice of interruption and restoration of supplies (Regulation 6) and the length of time of an interruption to supply (Regulation 7);
 - maintaining a minimum pressure of water in a communication pipe serving premises supplied with water (Regulation 7AA); and
 - flooding from sewers (Regulation 7B).
30. The GSS Regulations provide that if an undertaker fails to provide certain customer services in the manner set out (a “GSS event”), the undertaker must make a payment to that customer (a “GSS payment”).

¹ The Water Supply and Sewerage Services (Customer Service Standards) Regulations 1989 (as amended) were the relevant provisions in force at all material times, but were repealed and replaced by the Water Supply and Sewerage Services (Customer Service Standards) Regulations 2008, SI 2008 No. 594, with effect from 1 April 2008.

31. For the avoidance of doubt:

- (i) the “prescribed standards” are the standards of performance in connection with the provision of water and sewerage services prescribed under sections 38(2) and 95(2) WIA91 by the GSS Regulations;
- (ii) a “GSS event” describes a failure by the undertaker to meet the prescribed standards in circumstances where none of the exceptions to performance of that duty apply and which triggers a GSS payment (in other words, none of the exceptions to the duty to make a GSS payment applies);
- (iii) a “GSS payment” includes payment direct to a customer or crediting the sum in question to the customer’s account.

2.5 Provision of information to Ofwat

32. In respect of each reporting year, water and/or sewerage undertakers are required, by their Conditions of Appointment, to furnish certain information to Ofwat in the form of the June return. This is Ofwat’s primary source of information and data, (these terms are used synonymously throughout this schedule) which it relies upon to monitor each undertaker and to compare the performance of each undertaker relative to every other undertaker.
33. Table 6 of the June return furnishes information on the incidence of GSS events and the number of GSS payments made.
34. An independent consultant engineer (the "Reporter") reviews the customer service information and the undertaker’s statement of the methodology it has used to produce the customer service data furnished to Ofwat in the June return.

3. Facts and matters giving rise to the failure to meet standards of performance prescribed under the GSS Regulations

35. Under section 22A(4) WIA91, Ofwat is required to specify the acts or omissions which, in Ofwat's opinion, constitute the failure(s) in question.

3.1 Chronology of events

36. In June 2005 the Managing Director of Severn Trent approved the June return in respect of the reporting year in its entirety, including the Board overview, for submission to Ofwat on 10 June 2005. Severn Trent's Board overview stated that the "2004-05 results confirm[ed] that in all aspects of Customer Service [it had] exceeded [its] AMP3 targets".
37. On 4 November 2005 Ofwat issued MD209, "Reliability of Regulatory Information", a letter which was circulated to all Managing Directors of water and sewerage companies, reminding all undertakers of their obligations in relation to regulatory reporting.
38. In February 2006, Severn Trent informed Ofwat that it had discovered it had deliberately misreported aspects of its customer service performance over a number of years and that it had launched an internal investigation. This investigation was instigated by the Managing Director of Severn Trent, following a review by managers within the Customer Relations Department. The investigation covered performance against three of the customer service performance standards known as the DG Indicators: DG6 (billing contacts), DG7 (written complaints) and DG9 (telephone contacts), and GSS Payments made under GSS Regulations 4 (account queries and requests about payment arrangements) and 5 (written complaints).
39. On 7 March 2006, Ofwat published its 'Interim report on allegations made against Severn Trent Water' concerning allegations made by a Severn Trent employee of false reporting of information by Severn Trent (the "Ofwat Report"). The Ofwat Report concerned Severn Trent's provision of incorrect information relating to income and deliberately miscalculated information relating to bad debt. Allegations relating to the reliability of leakage data submitted by Severn Trent to Ofwat were the subject of an investigation by the Serious Fraud Office (the "SFO Investigation"). On 22 November 2007 the SFO announced that three charges are to be brought against

Severn Trent under section 207 WIA91, relating to leakage data provided to Ofwat in the June returns for 2000, 2001 and 2002.

40. In March 2006, Severn Trent agreed with Ofwat to extend its investigation to cover its performance against the remaining DG Indicators and GSS Regulations. On 7 April 2006, Severn Trent provided its interim report to Ofwat setting out the findings of its internal investigation in respect of DG6, DG7, DG9 and GSS Regulations 4 and 5.
41. In May 2006 Severn Trent and Ofwat jointly appointed Ernst and Young LLP (“E&Y”) to undertake an independent investigation into aspects of regulatory compliance and reporting by Severn Trent. The purpose of this investigation was to confirm the findings of Severn Trent’s investigation, identify any areas where further investigation was required and, where agreed by Ofwat and Severn Trent, undertake those further investigations and report on the findings.
42. On 8 June 2006 Ofwat served on Severn Trent the Section 203 Notice, requiring production of certain documents and the furnishing of certain information as set out in that Notice by 31 October 2006. In addition, Ofwat served on Severn Trent a Notice under section 22A(4) WIA91 (the “Section 22A(4) Notice”), stating that Ofwat was proposing to impose a penalty in respect of Severn Trent’s failure to meet standards of performance prescribed by the GSS Regulations.
43. On 10 July 2006 Severn Trent submitted its final report (the “Severn Trent Report”) on the extended internal investigation to Ofwat. The Severn Trent Report and annexes covered the handling and reporting of DG6, DG7 and DG9. It also included the additional work Severn Trent had carried out to review the systems and practices in place that it used to report on DG2, DG3, DG5 and DG8 for the June return and GSS processes.
44. In August 2006, Severn Trent agreed to report its performance against some of the DG Indicators and the GSS Regulations on a quarterly basis (the “quarterly reports”). The first quarterly report was provided for the months of April, May and June 2006 on 25 August 2006, and further reports have been received subsequently.
45. On 26 October 2006 Severn Trent requested an extension to the deadline for responses to both the Section 22A(4) Notice and the Section 203 Notice from 31 October 2006 to 31 January 2007. Ofwat granted this request on 16 November

2006.

46. On 31 January 2007 Severn Trent submitted representations in response to both the Section 22A(4) Notice (the "Section 22A(4) Response") and the Section 203 Notice (the "Section 203 Response"). Severn Trent did not, and does not, deny the fact that it has failed to meet the prescribed standards.
47. On 21 May 2007 Severn Trent gave Ofwat an undertaking ("the undertaking") accepting the principle that it should not benefit to the detriment of its customers from any irregularities that may be identified by the investigations. Severn Trent undertook to:
 - Pay in full any amounts found by the investigations to be due to customers who did not receive a payment to which they were entitled;
 - Adjust fully future prices if any irregularities identified by the investigations showed that Severn Trent had benefited in terms of its price reviews to the detriment of its customers; and
 - Confirm to Ofwat that it had identified the necessary steps and a timetable for implementation of adequate systems of control to fulfil its obligations.
48. E&Y provided a draft report in August 2007 which was agreed and accepted by Ofwat and Severn Trent. At this time there was just one outstanding issue and E&Y continued to work on this. In January 2008 E&Y provided its final report on the findings of its investigation to Ofwat and Severn Trent ("The E&Y Report"). This provided E&Y's conclusion to the issue that was outstanding when the draft report was produced and is otherwise unchanged from the agreed draft report.
49. In early 2006 Severn Trent began an exercise (the "quantification exercise") to determine the actual figures for customer service performance and to identify which customers should have received payments required under the GSS Regulations, which fulfils part of the undertaking. This work is subject to a number of limitations, discussed in section 3.3 below.

3.2 Evidence of the extent of failures to meet GSS standards

50. In satisfying itself that Severn Trent has failed to meet the standards of service prescribed under the GSS Regulations and in deciding whether to impose a penalty

and the amount of the penalty, Ofwat has considered the following:

- The Section 22A(4) Response;
- The Section 203 Response;
- The quarterly reports;
- The Severn Trent Report;
- The E&Y Report; and
- The quantification exercise.

3.3 Failures to meet GSS standards

51. Under section 22A(4)(a) Ofwat is required to set out the standards of performance which have not been met in relation to which the penalty is being proposed.
52. Severn Trent failed to achieve performance standards prescribed under the GSS Regulations at all material times during the period covered by the Section 22A(4) Notice. In the opinion of Ofwat, the acts or omissions set out in Table 1 below constitute the failures in question.
53. The numbers of GSS events presented in Table 1 are derived from the following sources:
 - (i) For GSS Regulations 4 and 5, the results of the quantification exercise; and
 - (ii) For the remaining GSS Regulations, the data submitted by Severn Trent in Table 6 of the 2006 June Return and in the first of the quarterly reports provided on 25 August 2006 (reduced pro rata to the number of days covered by this Notice). It should be noted that, for GSS Regulations 6 and 7B, the number of GSS payments made has been used as a proxy for the number of GSS events which occurred.

Table 1: Number of GSS events between 9 June 2005 and 8 June 2006

| GSS Regulation | Estimated number of GSS events 9 June 2005 to 8 June 2006 |
|-------------------------------------------------------------------------|------------------------------------------------------------------|
| Regulation 3 Making and keeping appointments | 329 |
| Regulation 4 Account queries and requests about payment arrangements | 2,841 |
| Regulation 5 Complaints about water or sewerage services | 3,227 |
| Regulations 6 and 7 Interruptions to supply | 3,013 |
| Regulation 7B Flooding from sewers | 664 |
| Total | 10,074 |

54. The foregoing represents the best particulars Ofwat is able to give. Full particulars of each individual GSS event referred to in the above table are, or should be, known to Severn Trent.
55. For the avoidance of doubt, the penalty to which the present Notice relates concerns Severn Trent's failure to achieve standards of performance prescribed under section 38(2) or 95(2) WIA91. The standards of performance do not include the payment of amounts prescribed under sections 38(3) and 95(3) WIA91 and this penalty does not relate to Severn Trent's failures to pay the amounts prescribed under those sections.
56. The quantification exercise is subject to a number of limitations. In particular, the quantification of the number of missed GSS payments in respect of GSS Regulation 4 (response to written billing queries) relied on extrapolations from a small sample of billing contacts. This means that there is considerable uncertainty around the actual number of GSS events which occurred. Severn Trent is also unable to identify the individual customers who did not receive the GSS payments to which they were entitled, and those customers will not therefore be adequately compensated. The quantification exercise has also not taken account of the additional issues affecting responses to both billing queries and complaints which were identified by E&Y.
57. As a result of the additional issues identified by both Severn Trent and E&Y, Ofwat considers that Table 1 may underestimate the actual number of GSS events that occurred. However, the estimates in Table 1 represent the best assessment of the level of failures, and the proposal to impose a penalty in this Notice is based on that

assessment.

3.4 Factors contributing to failures to meet the prescribed standards

58. Severn Trent and E&Y have identified a number of non-compliant practices and weaknesses in internal systems which contributed to and exacerbated the failures to meet the prescribed standards in this case.

3.4.1 Non-compliant practices used within the Customer Relations Department and concealment of failures to meet the prescribed standards

59. Non-compliant practices were developed within the Customer Relations Department which both contributed to the failures to meet the prescribed standards and concealed the true extent of failures under GSS Regulations 4 and 5 from Ofwat, the Reporter and other stakeholders.

60. One of these practices related to Severn Trent's handling of written customer complaints (under GSS Regulation 5). From August 2001, Severn Trent classified some written billing complaints as written account queries (a practice known within Severn Trent's Customer Relations Department as the "Telephone Cross procedure." CROSS was an acronym used for an IT system within the Severn Trent Customer Relations Department). The "Telephone Cross procedure" treated letters which contained both a general enquiry and an element of complaint (generally about problems in getting through to a Severn Trent telephone operator) as billing queries rather than complaints. The Severn Trent Report notes that: "[Severn Trent] practice has been to place such letters in the [account queries] process even if the letter contained a complaint". The Severn Trent Report goes on to note that 98% of the "Telephone Cross" contacts did contain a complaint, and that "the majority of [Severn Trent's] responses did not acknowledge the complaint."

61. Because the "Telephone Cross procedure" was inconsistent both with Severn Trent's published methodology and the requirements of the GSS Regulations, the "Telephone Cross procedure" was suspended whenever the Reporter was present. In the Executive Summary of the Severn Trent Report, Severn Trent acknowledged that "[Severn Trent] staff have confirmed that they were instructed not to follow this practice whenever [the Reporter was] present during a routine audit...".

62. The consequence of the “Telephone Cross” procedure was that many customer complaints were not acknowledged, and customers did not receive the substantive response required by GSS Regulation 5 (or, in many cases, any response to their complaints). The true extent of failures to meet GSS Regulation 5 was also concealed.
63. The Severn Trent Report also states that not all responses to billing queries issued were of sufficient quality to meet the standards specified in the GSS Regulations. GSS Regulation 4 sets minimum timescales for responding subsequently to written billing queries about the correctness of an account. Severn Trent noted that not all responses issued met the criteria for a substantive response: “quality failures have included the practice of issuing a simple holding letter and declaring it as a substantive response.” Where a holding letter was used and declared as a substantive response, it may have concealed the occurrence of a GSS event.
64. In addition to those practices identified by Severn Trent, E&Y identified the following practice within the Customer Relations Department, which contributed to the failures to meet the prescribed standards or concealed the true number of GSS events in relation to GSS Regulations 4 and 5:
- (i) “Weekend processing of written responses to customers’ billing queries and complaints are recorded as being resolved on a Friday even though they are not despatched until the following Monday. This under-records the number of days between receipt and dispatch”.
65. The effect of the various practices which concealed failures was that Ofwat was unaware of the true extent of failures to meet the prescribed standards and was therefore unable to take the appropriate corrective action.
66. Severn Trent misreported the incidence of some GSS events (and other customer service data), in the June return. Severn Trent’s misreporting of regulatory information is the subject of a separate proposal to impose a penalty under section 22A(4) WIA91 (the “Condition J/M Notice”), and is not considered further in this Notice.

3.4.2 Failures in systems and controls

67. In addition to the deliberate actions by staff within the Customer Relations Department, there were weaknesses in Severn Trent's systems and procedures which may have contributed to additional failures to meet the prescribed standards. Even where Ofwat does not have sufficient evidence to be certain that individual practices led directly to quantifiable failures to meet the prescribed standards, Ofwat considers that it is appropriate to take account of all the general underlying causes of the failures (including systemic weaknesses).
68. For GSS Regulation 3, Severn Trent identified a number of issues in its internal investigation. The Severn Trent Report noted: "A significant number of issues have been identified by [Severn Trent and the Reporter] with regard to the making, keeping and reporting of appointments. Processes are not consistently applied throughout the business and IT systems lack the capability to track performance".
69. For GSS Regulations 4 and 5, E&Y identified a range of issues:
- (i) "Two documents from early 2006 that referred to potential problems differentiating between items qualifying for GSS payments after 5 days and items qualifying for GSS payments after 10 days". Where Severn Trent was unable to distinguish between billing queries subject to the two different requirements, it may not have been aware of all failures to meet the more stringent 5-day deadline.
 - (ii) "Date fields relevant to DG reporting [and, potentially, GSS events] being changed without audit trail"; and
 - (iii) "Written complaints and billing queries which were not sequentially numbered meaning there is no check over completeness".
70. Severn Trent "identified a number of areas for improvement" in procedures for collecting, collating and verifying interruptions to supply, which may have led to undetected failures under GSS Regulation 7. The Severn Trent Report noted the following:
- (i) While the processes and procedures used in the Operations Department to report supply interruptions were robust, there were "no documented procedures for ensuring customers' complaints are routed to the correct team

or for ensuring that the necessary customer details are captured”;

- (ii) “In contrast, prior to April 2006... [there were] ... no documented procedures for the Engineering teams to follow for capturing the numbers of properties affected by interruptions or the duration of the interruption”; and
- (iii) “The lack of reporting procedures for the Engineering related supply interruptions mean that it is likely that [supply interruptions] performance reported since at least JR2000 would not have included all of the unplanned interruptions caused by engineering work”;

71. Ofwat recognises that the processes and systems that are required for the monitoring of performance against the prescribed standards and the accurate and timely identification of GSS events also support the making of payments and the reporting of GSS events and payments in the June return. For the purposes of this Notice, Ofwat has considered the inadequacies in Severn Trent’s systems and processes only to the extent that they have contributed to Severn Trent’s failures to meet the prescribed standards.

4. Ofwat's reasons for considering it appropriate to impose a penalty

72. Under section 22A WIA91, Ofwat is required to specify the “other facts” which, in the opinion of Ofwat, justify the imposition of the penalty.

73. Ofwat is, and remains, satisfied that Severn Trent failed to achieve the standards of performance prescribed under the GSS Regulations over the period from 9 June 2005 to 8 June 2006. In determining whether to propose to impose a penalty in this instance, Ofwat has had regard to the Statement of Policy.

4.1 Factors tending to make the imposition of a penalty more likely

4.1.1 The contravention or failure has damaged the interests of customers or other market participants or damaged the environment

74. Ofwat considers that the information and evidence submitted by Severn Trent indicates that, during the period covered by the Section 22A(4) Notice Severn Trent failed to meet the prescribed standards as prescribed by the GSS Regulations on at least 10,074 occasions. In particular, Severn Trent staff systematically failed to acknowledge certain customer complaints. Ofwat considers that delivering timely and appropriate responses to customers' complaints is an essential part of an undertaker's duty to its customers.

75. Where an undertaker fails to achieve the prescribed standards, it is required to make GSS payments to those customers affected by its failure. The making of those payments does not in itself prevent Ofwat from exercising its power to impose a financial penalty under section 22A(1) WIA91. Ofwat does, however, have regard to how an undertaker has fulfilled its duty to make GSS payments in its consideration of aggravating and mitigating factors.

76. The GSS Regulations deal with critical aspects of the water and sewerage service, namely continuity of water supply and effective removal of sewage. They also deal with the responsiveness of companies to customers' inquiries and complaints, requests for changes to their billing arrangements and the making and keeping of appointments. The failure to achieve a GSS standard in any individual case is not a failure to provide a good service but a failure to meet the minimum standard of service to which the Secretary of State considers the customer is entitled. The GSS

standards cover narrowly defined aspects of service and most undertakers have customer service compensation policies which, in itself, recognises the limitations of the GSS Regulations.

77. Ofwat considers that Severn Trent's failures to achieve the prescribed standards damaged the interests of customers. Those failures were exacerbated by Severn Trent's failure to maintain effective systems to monitor and control performance against the prescribed standards and by the actions of staff within the Customer Relations Department. Given the extent of Severn Trent's failure to provide those minimum standards, coupled with its inability to monitor accurately the standards of service provided, Ofwat considers that it should impose a financial penalty.
78. Ofwat has not sought to quantify, in money terms, the harm to each individual customer affected by each individual failure by Severn Trent to meet the relevant standard of performance. Such harm would be impossible to quantify on the basis of the information furnished by Severn Trent to Ofwat. It would be extremely difficult and time-consuming to quantify, even if Ofwat had full information of the circumstances of each individual failure and each individual customer. Further, much of the harm would be "general" in nature (e.g. inconvenience, distress, etc) rather than "special" (i.e. quantifiable financial loss).
79. Ofwat recognises that the GSS Regulations provide for payments to be made to individual customers where a GSS event occurs and that such payments are compensatory in nature (in the sense that they are paid to the customer in respect of the incident) rather than penal. GSS payments recognise that failure to achieve the prescribed standards of performance damages the interests of customers. GSS payments do not, however, purport to provide full compensation to individual customers in respect of the failure to meet the prescribed standard of performance in any given situation. Nor do GSS payments rectify all the damage that failures to meet the prescribed standards have caused to the interests of customers.
80. In accordance with the GSS Regulations, customers may have a reasonable expectation that where a company fails to meet the GSS Standards they will receive a compensatory payment within a defined time period. Where a company fails to make this payment within the time period they have failed to meet reasonable customer expectations.

81. For the avoidance of doubt, however, Ofwat is not proposing to impose a penalty for failure to achieve the prescribed standards because specific, quantifiable harm has been caused to specific, identifiable customers and/or because GSS payments made, or to be made, by Severn Trent do not adequately compensate specific individual customers. The imposition of a financial penalty and/or the amount of that penalty under section 22A WIA91 are not dependent on the fact, terms, nature or extent of quantifiable loss or damage caused by any relevant contravention or failure. The GSS payment regime pursues a different aim from the financial penalties regime. As stated above, GSS payments are compensatory, not penal. By contrast, financial penalties are, by definition, penal in nature, not compensatory. As stated in the Statement of Policy, however, and as noted above, Ofwat has had regard to harm to consumers and to payments made by Severn Trent in respect of such harm when deciding to impose a penalty and the amount.
82. Ofwat also considers that the harm to customers (and others) caused by Severn Trent's failure to meet GSS performance standards is different both in kind and in quantum from the harm to customers caused by Severn Trent's contravention of Conditions J and/or M (as covered by the Condition J/M Notice).
83. Severn Trent's failures have created a risk that other market participants will suffer a degree of reputational damage. However, the risk is difficult to assess and Ofwat has not therefore taken it into account in assessing the imposition of a penalty.

4.1.2 Applying a penalty would be likely to create an incentive to comply and deter future contraventions or failures

84. Ofwat acknowledges that Severn Trent has, since the issue first came to light, made efforts to develop and implement both interim measures and action plans for process improvements to enhance its ability to achieve at least the standards of performance prescribed under the GSS Regulations and to identify missed GSS events and make payments. However, the circumstances of this case and the fact that so many GSS events have occurred indicate that the obligation to make a GSS payment in response to any event has not provided, and will not provide, a sufficient incentive to achieve the standards of performance prescribed under the GSS Regulations. Ofwat considers that in this case a financial penalty will deter other water and/or sewerage undertakers from not meeting their obligations under the GSS Regulations and

provide an incentive to undertakers to ensure they have adequate systems in place to recognise GSS failures and make GSS payments at the time the failure occurs.

85. Ofwat has taken account of the interim measures taken and action plans put in place by Severn Trent to enhance its ability to achieve the standards of performance prescribed under the GSS Regulations. Those measures and plans are considered further in relation to mitigating factors. Ofwat has also taken into account the various payments made and to be made by Severn Trent, the voluntary reduction in allowed revenue and the steps taken by Severn Trent to improve GSS compliance. These factors are dealt with in section 5.5 of this Schedule.
86. Severn Trent's failures were exacerbated both by non-compliant practices used within Severn Trent's Customer Relations Department and by inadequacies in Severn Trent's systems and processes for monitoring and controlling performance against the prescribed standards. Ofwat considers it necessary and desirable to deter future such failings at both Severn Trent and other undertakers.

4.2 Factors tending to make the imposition of a penalty less likely

4.2.1 The contravention or failure is or was of a trivial nature

87. The customers of Severn Trent did not receive the required standards of performance on a total of 10,074 occasions during the period 9 June 2005 to 8 June 2006. As set out in section 3 above, Severn Trent has failed to provide the required standards of performance and consequently has provided service to customers that was below the minimum level required across a range of activities.
88. The failures occurred as a result of deliberate action to show a better level of performance than was actually the case. Severn Trent also failed to ensure it has appropriate systems in place to meet its obligations under the GSS Regulations and to monitor adequately its compliance with the GSS Regulations and hence the level of service provided. Ofwat therefore considers the failure to achieve the required standards of performance to be non-trivial.
89. Furthermore, Ofwat considers that the fact that Severn Trent has attributed the failure to meet the prescribed standards to operating deliberately non-compliant practices and to systemic failures to be more culpable and deserving of a penalty than if these

contraventions had been attributed to an isolated error.

4.2.2 The contravention or possibility of a contravention would not have been apparent to a diligent undertaker

90. Ofwat considers that Severn Trent, as a diligent undertaker, should have had in place systems to ensure it met its statutory obligations under the GSS Regulations. Severn Trent should also have ensured that it was properly able to monitor its compliance with the GSS Regulations and to act as necessary to ensure its ability to achieve at least the minimum standards of performance prescribed.
91. Furthermore, a diligent undertaker would not have allowed a culture to exist under which:
- (i) staff adopted interpretations of the GSS Regulations which were contrary to the best interests of customers;
 - (ii) staff took steps to develop and use practices which not only compromised Severn Trent's ability to meet the prescribed standards, but also neglected its obligation to its customers to meet those standards;
 - (iii) concerns about non-compliant practices raised by individual employees were disregarded, even when raised with the appropriate level within the Customer Relations Department; and
 - (iv) practices which led to concealment of performance against the prescribed standards were not only considered, but also were implemented.
92. Ofwat considers that, had Severn Trent established appropriate systems, processes and controls, then Severn Trent would have been able to identify the failings and either Severn Trent would have been able to take action earlier to address its performance or Ofwat would have been able to take regulatory action against Severn Trent to require it to improve its compliance with the prescribed standards.
93. Accordingly, Ofwat considers that Severn Trent's failures to meet the standards of performance prescribed under the GSS Regulations should have been apparent to a diligent undertaker.

4.3 Double jeopardy

94. Ofwat has drawn a careful distinction between the deliberate manipulation of the written complaints data (under the telephone cross procedure) that led to the failures to meet the appropriate GSS standards and the deliberate misreporting in relation to Conditions J and/or M. It is only the failure to meet the GSS standards which are considered when assessing the appropriateness of a penalty and its amount in this Notice.
95. Ofwat is not aware of any prosecution which has been instigated or which has been proposed in respect of Severn Trent's failure to meet the standards of performance prescribed under the GSS Regulations.

4.4 Appropriateness of a penalty in this case

96. Ofwat considers that the imposition of a financial penalty is and continues to be justified in this case, for the following reasons:
- (i) Severn Trent's failures to meet the prescribed standards (and, in particular, Severn Trent's failures to acknowledge certain customer complaints) have damaged the interests of customers;
 - (ii) Ofwat considers it necessary and desirable to signal to both Severn Trent and other undertakers that it takes undertakers' obligations to meet the prescribed standards very seriously;
 - (iii) Ofwat considers it appropriate to provide an incentive to both Severn Trent and other undertakers to ensure they adequately monitor and control performance against the prescribed standards and are able to recognise GSS payments and make GSS payments at the time the failure occurs; and
 - (iv) Ofwat considers it appropriate to discourage the use of the non-compliant practices evident in this case.

5. Assessment of the amount of the penalty

97. Under section 22A(4) WIA91, Ofwat is required to specify the “other facts” which, in the opinion of Ofwat, justify the amount of the penalty proposed.
98. In determining the amount of the penalty proposed to be imposed, Ofwat has had regard to all the circumstances of the case and to the Statement of Policy.
99. Pursuant to section 22A(11) WIA91, no penalty imposed by Ofwat under section 22A may exceed 10% of the applicable turnover of the company, determined in accordance with the Water Industry (Determination of Turnover for Penalties) Order 2005 (SI 2005 No. 477).

5.1 The maximum possible penalty under section 22A WIA91

100. The proposed penalty to which this notice relates concerns Severn Trent's failures to meet the standards of service prescribed under the GSS Regulations. The obligations imposed by the GSS Regulations, and the failure to meet those obligations, relate to Severn Trent's regulated activities as both a water and a sewerage undertaker. In the circumstances, Ofwat considers that the applicable turnover for the purposes of Article 3 of SI 2005/477 is Severn Trent's turnover derived from its functions both as a water and as a sewerage undertaker. Consequently, the proposed penalty has been determined by reference to Severn Trent's combined service turnover.
101. Severn Trent's applicable turnover derived from its activities as both a water and sewerage undertaker for the last business year preceding the date of the Section 22A(4) Notice was £1,127.5 million. Accordingly, the maximum penalty for Severn Trent's contravention in this case is 10% of £1,127.5 million, i.e. £112.8 million.

5.2 The level of the penalty

102. In considering the case for a penalty Ofwat is satisfied that Severn Trent has failed to meet the standards of performance prescribed by the GSS Regulations and that it is appropriate to impose a financial penalty.
103. The amount of any penalty to be imposed is not prescribed by WIA91 or by the

Statement of Policy. The combined effect of WIA91 and the Water Industry (Determination of Turnover for Penalties) Order 2005, however, is that any penalty that Ofwat decides to impose must lie in the range between a nominal sum and 10% of the applicable turnover of the company, as defined.

104. Ofwat also considers that Severn Trent's failures to meet the GSS standards are less serious than Severn Trent's contravention of Condition J and/or M of its Conditions of Appointment, which are the subject of the J/M Notice. The contraventions of Condition J and/or M have a far wider impact than the harm suffered by those customers of Severn Trent who did not receive the standard of performance to which they were entitled under the GSS Regulations. Misreporting regulatory information damages the interests of all water and sewerage customers, as it prejudices Ofwat's ability to make comparisons and regulate in the interests of all customers.
105. Ofwat has also considered the impact of the failures, which have damaged the interests of Severn Trent's customers.
106. The imposition of a penalty will create an incentive on Severn Trent to comply now and in the future. It will also place an incentive on undertakers more widely to comply with their obligations under the GSS Regulations and to ensure that they have robust systems and processes in place.
107. Ofwat considers that the deterrent effect of the fine on the industry is significantly greater than the quantum of the fine that is proposed in this case. The penalty proposed on Severn Trent will deter it from failing in future, but will also deter the industry more widely from failing to meet the obligations under the GSS Regulations.
108. Ofwat considers that setting a penalty by reference to a company's turnover is fair, reasonable and appropriate especially where the harm is suffered by the regulatory regime as a whole or where the full extent or the harm caused to customers and others cannot be quantified. This approach has the merit that smaller water companies are not subject to disproportionately high penalties whilst larger companies are provided with a sufficient incentive to comply. Ofwat recognises that this approach will mean that, all other things being equal, larger companies will face significantly higher monetary penalties in absolute monetary terms than smaller companies for any given contravention. For Ofwat it is important that the impact of any penalty should be broadly the same and given the diversity of size of companies

within the industry this is best achieved by reference to turnover rather than to absolute financial amounts. This is a reflection of the diversity in terms of size of the water and sewerage companies operating within the industry. Severn Trent is one of the largest companies operating in the industry in terms of its turnover (it represents almost 15% of total industry turnover) and serves almost 9 million customers, most of whom do not have a choice of supplier. If an equivalent penalty in absolute terms were imposed on Tendring Hundred Water Services (one of the smallest water companies), it would represent over 7% of that company's turnover. Setting penalties solely by absolute monetary value could mean that a penalty that represented a significant deterrent for a small company would be inconsequential for a larger company and consequently would have little or no deterrent value. The basis of calculation is a matter well within Ofwat's discretion and in this instance, consistent with its past practice and the practice of the EC Commission, the Office of Fair Trading and other regulators.

5.2.1 The seriousness and duration of the failure

109. As set out in section 2.4 of this Schedule, Severn Trent is required to provide the minimum standards of service prescribed under the GSS Regulations.

110. In this case, Severn Trent failed to provide the standards of service prescribed under the GSS Regulations on 10,074 occasions throughout the period covered by this Notice. These are failures to achieve the minimum acceptable standards of performance prescribed under the GSS Regulations. The standards set out in the GSS Regulations should not, however, be equated with the higher standard of service which customers should – and generally do – receive. Ofwat considers that ensuring that undertakers achieve, at the very least, the minimum levels of customer service is an important part of its role as a regulator. As set out in section 2.4 above, the GSS Regulations set statutory minimum standards of service for fundamental aspects of the service which water and sewerage undertakers provide. Continuity of supply and avoidance of flooding from sewers are very important to customers. Prompt and effective responses to customers' concerns and requests for action, including meeting appointments, are widely accepted as essential features of customer service across all sectors of the economy. The standards set out in the GSS Regulations have an important and valuable role in the water and sewerage sectors where the services provided are fundamental to customers' health and well-being. That role is all the more important because undertakers are largely monopoly

suppliers and customers cannot choose to switch their supplier in the event of dissatisfaction with the level of service provided.

111. With regard to the duration of the failures, Ofwat notes that Severn Trent's quantification exercise has demonstrated significant numbers of failures to meet the prescribed standards in all years back to at least 2002. As set out in section 2.3, statutory restrictions mean that Ofwat can only impose a penalty in respect of the period between 9 June 2005 and 8 June 2006. The purpose of referring to the fact and extent of Severn Trent's failure to achieve GSS performance standards before the penalty period is to indicate that those failures that occurred during the penalty period were not the result of an isolated incident, and nor were they in any way unusual, unexplained or as a result of unforeseen circumstances.

5.2.2 The degree of nuisance, harm or increased cost incurred by customers, other market participants or the environment

112. It is Ofwat's view that customers of Severn Trent incurred nuisance or harm to the extent that a proportion of Severn Trent's customers received standards of performance that were below the statutory minimum prescribed under the GSS Regulations.
113. The GSS Regulations establish a simple mechanism to protect customers who fail to receive the prescribed standards of performance. Ofwat has in the past explained (in a letter to all managing directors of water and/or sewerage companies, entitled "MD153: Review of the guaranteed standards scheme") that the GSS Regulations are not intended to cover every situation where financial redress may be appropriate. The GSS Regulations provide clear standards and guarantee a certain level of payment for failure to meet those standards. Payments under the GSS Regulations are not intended to represent full redress for every individual service failure, and neither preclude payment or further compensation by undertakers nor prevent a customer from taking other action, including legal action, to secure redress.
114. Ofwat has not sought to quantify the harm to each individual customer affected by each individual failure by Severn Trent to meet the relevant standard of performance. Such harm would be impossible to quantify on the basis of the information furnished by Severn Trent to Ofwat to date and would be extremely difficult and time-consuming to quantify even if Ofwat had full information of the circumstances of each

individual failure and each individual customer. Further, much of the harm would be “general” in nature (e.g. inconvenience or distress) rather than “special” (i.e. quantifiable financial loss). The following paragraphs set out examples of the harm customers may have suffered as a result of Severn Trent’s failures.

115. Where Severn Trent or its contractors failed to meet the standards prescribed under GSS Regulation 3 for making and keeping appointment, customers may have incurred additional costs in re-contacting Severn Trent and in further lost income or time in arranging and meeting any replacement appointments.
116. Where Severn Trent failed to meet the standards prescribed under GSS Regulation 4 for responding to written billing queries, or requests for a change of payment method, customers may have been inconvenienced by the delay in dealing with their correspondence. They may also have incurred additional costs and time in re-contacting Severn Trent or additional interest or bank charges as a result of incorrect bills or payment arrangements.
117. Where Severn Trent failed to meet the standards prescribed under GSS Regulation 5 for responding to written complaints, customers may have been inconvenienced by the delay in dealing with, or failure to deal with, their correspondence. Customers with complaints about difficulties with Severn Trent’s telephone system were completely ignored through the “Telephone Cross procedure”. Customers have a right to expect a speedy and substantive response to their complaints; Severn Trent’s deliberate failure to acknowledge (and therefore respond to) complaints has damaged the interests of its customers.
118. Where Severn Trent failed to meet the standards prescribed under GSS Regulations 6 and 7 in respect of interruptions to supply, customers may have suffered inconvenience and risk of harm to their health. Unexpected interruptions to supplies can be expected to have the greatest impact on customers as they will not be in a position to store any water or take other precautions. In such circumstances customers are likely to incur additional costs in making alternative arrangements such as buying bottled water or in travelling to areas where there is a water supply. Business customers without water storage risk losing business or production, or incurring additional costs to secure the water they need.
119. Any failure to provide the information required by the GSS Regulations when

supplies are interrupted unexpectedly may have caused concern or distress to customers, particularly the more vulnerable; customers may also have incurred additional inconvenience and costs in trying to contact Severn Trent.

120. Where Severn Trent failed to meet the standards prescribed under GSS Regulation 7B in respect of flooding from sewers, customers will have experienced considerable nuisance and distress. They may have incurred costs associated with cleaning the affected areas and replacing damaged goods particularly where those losses were not covered by insurance. Where losses were covered by insurance, the customer may have incurred other losses in the form of increased premium and excess charges. Business customers are likely to have lost business or production.

5.2.3 Any gain (financial or otherwise) made by the undertaker as a result of the failure

121. Although Severn Trent's customer service costs per customer are not the lowest amongst the water and sewerage companies, Severn Trent has not met the prescribed standards at its current level of expenditure. In order to meet the prescribed standards, Ofwat considers that Severn Trent is likely to incur additional costs (either through capital investment or increased operating costs).
122. In the Section 203 Response, Severn Trent identified an additional £1.6 million of annual expenditure it had already incurred to improve its performance against a number of metrics (including the prescribed standards), and a further £450,000 of capital expenditure it was likely to incur for further improvements. Severn Trent also noted that the costs of necessary upgrades to IT systems had not been evaluated. Severn Trent also estimated that the costs of the internal investigations, the quantification exercise and the E&Y Investigation were likely to exceed £500,000.
123. Ofwat considers that Severn Trent would have reasonably been expected to make the improvements necessary to meet the prescribed standards if the company itself had identified the need to reduce the occurrence of GSS events or if Ofwat had been informed of the true level of failures. Severn Trent failed to make those improvements because Severn Trent's system to monitor and report the number of failures against the GSS Regulations was inadequate.
124. However, as noted in Section 3, the systems and processes required for accurate

and timely identification of GSS events also support the making of payments and reporting of events and payments in the June return. Severn Trent's contraventions of its Conditions of Appointment in respect of regulatory reporting are the subject of the Condition J/M Notice. Ofwat recognises the overlap between the costs of improvements to systems and processes for identifying events internally and monitoring of performance, and those for ensuring accurate reporting to Ofwat of performance under the GSS Regulations. This has been taken into account in determining the quantum of the penalty.

125. Severn Trent also failed to make GSS payments (and any related penalty payments) in all instances where they were due. Severn Trent's quantification exercise has identified GSS payments (including some penalty payments) totalling £182,040 that should have been paid in respect of GSS Regulations 4 and 5 during the period covered by this Notice. These payments have been made retrospectively where individual customers can be identified, and Severn Trent has agreed to reduce prices to customers more generally to reflect those payments from the period covered by this Notice which cannot be made. The compensatory payments made (and those which have not been made) are considered further in relation to aggravating and mitigating factors below.

5.2.4 Precedents set under equivalent provisions for other utilities and public services

126. Paragraph 3.4 of Ofwat's Statement of Policy states that "once it has been decided that a penalty should be imposed the enforcement authority must consider the appropriate level. Any penalty must be reasonable in the circumstances of the case. Factors relevant to decisions on the broad level of a penalty will include ... precedents set under equivalent provisions for other utilities and public services".
127. Ofwat considers this limits the cases to which Ofwat is required to have regard by the terms of the statement of policy, to the following criteria:
- the case must have been considered and decided under equivalent provisions;
 - the case must relate to "other utilities and public services";
 - the case must in some sense be of use as a precedent to the case in question.

Without prejudice to the foregoing, Ofwat will always consider any representations as to the relevance of regulatory decisions not satisfying those criteria.

128. The cases which have informed Ofwat's proposal in this Notice are discussed in more detail below.
129. In considering the degree of seriousness of Severn Trent's failures to meet the standards of service prescribed by the GSS Regulations, Ofwat has been mindful of the penalty of 0.7% of turnover amounting to £8.5 million it imposed on United Utilities Water plc ("United Utilities"), pursuant to section 22A WIA91, on 22 June 2007, in respect of United Utilities' contraventions of Condition F for its Conditions of Appointment. The contraventions in the United Utilities case are different from and not directly comparable to the failures in this case. In the United Utilities case the infringements concerned a breach of Condition F of the company's Conditions of Appointment which places a prohibition on companies cross-subsidising their associate companies.
130. Ofwat has taken closest account of its current proposal to impose penalties on Thames Water Utilities Limited ("Thames Water") and the penalty it has imposed on Southern Water Services Limited ("Southern Water") in respect of failures to meet the prescribed GSS Standards. Ofwat considers that both cases are comparable to this case because they also concern failures to provide the minimum standards of service prescribed by the GSS Regulations. This is reflected in the proposed penalty for Thames Water and the penalty imposed on Southern Water. Full particulars are reflected in the Notice published on 9 January 2007 for Thames Water which proposes a penalty of 0.1% of turnover (£1.4million) and for Southern Water a Notice published on 8 February 2008 which imposed a penalty of 0.1% of turnover (£0.47million).
131. Ofwat found precedents from other regulators to be of some assistance to the consideration of the penalty proposed in this Notice.
132. In August 1997 the Office of the Rail Regulator (now the Office of Rail Regulation) ("ORR") fined National Rail Enquiries Services for failure to meet its target of 90% of calls; Ofgem fined three power companies in 2003 – 2004 for wrongly refusing to allow customers to switch supplier. On three separate occasions, Postcomm fined

the Royal Mail (in December 2003, April 2006, and June 2006) for various different customer service failures. These cases demonstrate the gravity with which other economic regulators view failures to provide required standards of customer service.

133. In the National Rail Enquiry Services case, the ORR adopted a sliding scale methodology in determining the appropriate penalty, which was unique and specific to the facts of the case and was imposed and notified to the undertaking in advance of the conduct. In light of those features, Ofwat considered that the approach to quantum was wholly different and could not derive any assistance from this approach.
134. The power companies fined by Ofgem were operating in a market in which consumers have the option to switch to an alternative supplier. Similarly, customers of Royal Mail also have some alternative services available to them which may be substitutable in some circumstances, such as e-mail and alternative delivery services, although Ofwat acknowledges that such services can only be a very partial and hence imperfect substitute for mail services.
135. The amounts proposed in relation to other markets were of little assistance to Ofwat in reaching its decisions because they turned on their own facts.

5.2.5 The level of any other penalty already or potentially imposed through other regulatory means in relation to the same contravention

136. No other penalty has been imposed or is proposed in relation to Severn Trent's failure to meet the prescribed standards under GSS Regulations, although Ofwat has also issued the Condition J/M Notice on 7 April 2008, Ofwat has ensured that the penalty proposed under this Notice relates exclusively to Severn Trent's failures to meet the prescribed standards and not to any breaches of its Conditions of Appointment in respect of regulatory reporting.

5.3 The broad level of the penalty

137. Having regard to each of the relevant facts and matters, Ofwat judges that the level of penalty should be calculated by reference to a starting point of 0.6% of turnover. This represents the broad level of the penalty.

138. As set out in the Statement of Policy, once the broad level of the penalty has been considered, other factors such as aggravating and mitigating factors may be taken into consideration

5.4 Aggravating factors

139. Ofwat considers that the following factors are relevant aggravating factors in this case.
140. Severn Trent staff knowingly processed correspondence containing both a complaint element and a billing query incorrectly, and in a manner which ultimately led to the complaints not being acknowledged. Ofwat considers that such treatment of customer complaints (however mild) is inappropriate and a serious matter.
141. Although there is no evidence that senior management instigated these non-compliant procedures, documents detailing these practices were regularly circulated to senior management within the Customer Relations Department. Senior management also failed to exercise an adequate degree of control over the practices used by Severn Trent staff, which resulted in non-compliant procedures being adopted.
142. For the failures in respect of GSS Regulation 4, the quantification exercise identified 2,841 GSS payments which had not been made. The vast majority of the customers to whom payments should have been made cannot be identified, and those customers will not individually receive the GSS payments to which they were – and remain – entitled.
143. However, whilst Ofwat considers that these factors are relevant aggravating factors, to avoid double jeopardy Ofwat has not attached any weight to them in this case.

5.5 Mitigating factors

144. Ofwat considers that the following factors mitigate the seriousness of Severn Trent's failures to meet the prescribed standards.
145. Severn Trent undertook an internal investigation into the problem, and voluntarily reported the results of that investigation to Ofwat. Severn Trent also agreed to

Ofwat's request to extend its investigation into other areas, and to the appointment of independent investigators. Severn Trent cooperated with the E&Y Investigation, but the level of co-operation was no more that Ofwat would expect of any undertaker.

146. Severn Trent acceded to Ofwat's request that it give an undertaking to co-operate fully with the necessary independent investigations, to pay in full any amounts found by the investigations to be due to customers and to confirm that it has adequate systems of internal control and planning to fulfil its functions and meet its obligations as an undertaker. This undertaking is wider in scope and duration than the issues for which Ofwat is now considering a penalty in this Notice and Severn Trent is undertaking necessary steps to fulfil these obligations.
147. In December 2006, Severn Trent established an action plan to address the weaknesses found. That action plan has been further developed to deal with additional issues, and progress against the plan is being reported to Ofwat.
148. Severn Trent has made retrospective payments to the affected individuals in respect of the majority of failures against GSS Regulation 5 (including 3,075 of the 3,227 failures within the period covered by this Notice). Severn Trent has also agreed to reduce prices to all customers to cover the payments it should have made for the remaining failures against GSS Regulation 5 and the failures against GSS Regulation 4. Severn Trent's payments cover all GSS events identified by the quantification exercise, and not merely those events which fall within the period covered by this Notice. Although these are payments that customers should have received, Ofwat recognises that Severn Trent could not now be compelled to make them.
149. Severn Trent has also agreed to pay additional sums equivalent to penalties for late payment of GSS amounts under GSS Regulation 7C. As these payments are only payable if a customer makes a claim for payment, Ofwat acknowledges that Severn Trent has gone beyond its obligations in making payments against this GSS Regulation.
150. Having regard to the relevant aggravating and mitigating factors, a deduction of 0.5% of applicable turnover is proposed.

5.6 The penalty which Ofwat is proposing to impose

151. Ofwat considers that Severn Trent's failures to meet the prescribed standards, and the underlying causes of those failures, are sufficiently serious to merit the proposal to impose a penalty.
152. In this instance, the failures directly damaged customers' interests. Severn Trent provided a sub-standard service to its customers and did not make GSS payments to those customers that were entitled to them at the time that the company failed to provide the minimum standards of service required by the GSS Regulations. However, Ofwat acknowledges that Severn Trent has taken steps to remedy the harm caused to customers therefore this is a subsidiary factor in determining the quantum of the penalty.
153. In its consideration of the amount of the penalty proposed to be imposed (as varied), Ofwat accepts that Severn Trent has not gained significantly from its failures. Ofwat has also given Severn Trent credit for the mitigating factors in this case, including Severn Trent's reporting of the failures and co-operation with the investigation, and the steps taken by Severn Trent to compensate customers for its failings and to improve its future performance. In this case, the mitigating factors have led to a significant net reduction in the overall penalty.
154. In arriving at a level of fine that is proportionate, Ofwat has considered what level of fine would reduce the probability of the conduct being repeated. In order to deter future contraventions, whether by Severn Trent or by other undertakers, Ofwat has considered the deterrent effect of the fine on Severn Trent and on other undertakers. Of necessity, this has involved consideration of Severn Trent's ability to pay any fine as measured by reference to its turnover. As set out above, Ofwat considers this approach fair, as it ensures smaller water companies are not subjected to penalties which are disproportionately high relative to their turnover, whilst still allowing penalties for larger water companies at levels which are capable of deterring them from contravening regulatory requirements.
155. Ofwat therefore considers it appropriate to vary the penalty proposed to be imposed to 0.1% of Severn Trent's applicable turnover in 2005-06. This amounts to £1.1 million.

6. How to make representations or objections

156. Pursuant to section 22A(5) WIA91, Ofwat, in publishing a notice under that section of a proposal to impose a penalty under section 22A(1) WIA91, is required to specify a period (of not less than twenty-one days from the date of publication of that notice) within which representations or objections with respect to the proposed penalty may be made.
157. Ofwat has decided to, in this case, specify a period of 28 days from the date of publication of this Notice within which any representations or objections with respect to the proposed penalty may be made. Accordingly, any such representations or objections should be made so as to be received by Ofwat by 5 pm on 6 May 2008.

Representations or objections should be made in writing to:

Ingrid Olsen
Head of Enforcement Policy
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

E-mail: ingrid.olsen@ofwat.gsi.gov.uk

and clearly marked "Severn Trent Water Proposed Penalty – Standards of Performance".

158. Representations and objections will be placed in our library and on our website and made available to the public unless the person making those representations/objections has, in so doing, clearly indicated that he did not wish this to happen. In general, Ofwat will seek to honour any requests for representations/objections to be kept confidential. There may, however, be circumstances in which representations/objections may have to be disclosed notwithstanding the wishes of the makers of those representations (for example, if disclosure is required under the Freedom of Information Act 2000 or in legal proceedings).

ANNEX 1

Notice, under and in accordance with section 22A(4) of the Water Industry Act 1991 (as amended), of the Water Services Regulation Authority's proposal to impose a penalty on Severn Trent Water Limited

This document constitutes a notice given under and in accordance with section 22A(4) of the Water Industry Act 1991 (as amended) (the "WIA91"). The background and context to this notice are set out in sections 1 to 8 below. This notice states that:

- the Water Services Regulation Authority ("Ofwat") proposes to impose a penalty on Severn Trent Water Limited ("Severn Trent Water");
- Ofwat is satisfied that Severn Trent Water has failed to achieve standards of performance prescribed under sections 38(2) and 95(2) WIA91, namely the standards in the Water Supply and Sewerage Services (Customer Service Standards) Regulations 1989 (as amended) (the "GSS Regulations"). The reasons for this are set out at sections 4 and 5 below;
- the proposal to impose a penalty is in respect of Severn Trent Water's failure to achieve standards of performance prescribed under sections 38(2) and 95(2) WIA91, namely the GSS Regulations, at all material times between 9 June 2005 (the date twelve months prior to the date of this notice) and the date of this notice;
- the omissions which, in the opinion of Ofwat, constitute the failures in question and which justify the imposition of a penalty are set out in sections 4 to 7 below;
- however, Ofwat requires Severn Trent Water to provide further information as to the extent of the failures to be able to quantify fully the amount of the proposed penalty;
- it is likely that Ofwat will vary the proposal stated in this notice once Severn

Trent Water has provided information as to the full extent of the failures; if so, Ofwat will be required to give notice, as required by section 22A(5) WIA91, setting out the proposed variation and the reasons for it and allowing a period (not being less than twenty-one days from the date of publication of the notice) within which representations or objections with respect to the proposed variation may be made;

- Ofwat is also considering whether Severn Trent Water has or may have contravened conditions of its appointment by providing Ofwat with false information in relation to customer services and whether it would be appropriate to impose a separate penalty on Severn Trent Water in respect of those contraventions; this notice is without prejudice to any penalty Ofwat may impose or propose to impose, or any other action Ofwat may take, in respect of any such contraventions;
- representations or objections with respect to this proposed penalty may be made by 5pm on 31 October 2006; representations or objections should be made to Sue Cox, as set out below.

Sue Cox
Acting Head of Consumer Affairs
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Or by e-mail to sue.cox@ofwat.gsi.gov.uk

Representations and/or objections, which should be made in writing, should be clearly marked 'Severn Trent Water Proposed Penalty'.

Representations and/or objections will be placed in our library and made available to the public, unless you have clearly indicated that you do not wish

this to happen. In general, we will honour this request, but there may be circumstances in which, under the Freedom of Information Act 2000, we would be obliged to disclose responses.

1. Regulatory and Legal Framework

On 1 April 2006, a body corporate known as the Water Services Regulation Authority replaced the officer known as the Director General of Water Services (the "Director") (section 34 of the Water Act 2003 (the "WA03") and article 4 of the Water Act 2003 (Commencement No 5, Transitional Provisions and Savings) Order 2005, SI 2005 No 2714). On the same day the functions of the Director were transferred to the Water Services Regulation Authority under section 36 WA03 and the Water Services Regulation Authority Transfer Scheme 2006.

Anything done by the Director for the purpose of or in connection with any of his functions and which is in effect immediately before the transfer is treated as if done by the Water Services Regulation Authority (Schedule 3, paragraph 6(1) WA03). The transfer of the functions does not affect the validity of anything done by the Director before the transfer takes place (Schedule 3, paragraph 6(2) WA03). The Water Services Regulation Authority is substituted for the Director in any document relating to anything transferred (Schedule 3, paragraph 8). In this notice, the term "Ofwat" is used to mean both the Water Services Regulation Authority from 1 April 2006 and the Director prior to 1 April 2006.

Ofwat is the economic regulator for the water and sewerage industry in England and Wales. Its primary duties are (so far as relevant):

to further the consumer objective (namely to protect the interests of consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services);

to secure that the functions of a water undertaker¹ and of a sewerage undertaker are properly carried out as respects every area of England and Wales; and

to secure that undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions.

2. Penalties

Under section 22A(1)(a) WIA91² Ofwat may impose on an undertaker a penalty of such amount as is reasonable in all the circumstances of the case where, amongst other things, it is satisfied that the undertaker:

- has contravened or is contravening any condition of its appointment;
- has failed or is failing to achieve any standard of performance prescribed under section 38(2) or 95(2) WIA91; or
- has contravened or is contravening any statutory or other requirement which is enforceable under section 18 WIA91 and in relation to which Ofwat is the enforcement authority.

By section 22A(10) WIA91, the power to impose a penalty under section 22A is not

¹ Companies holding appointments as water only or water and sewerage undertakers under Chapter I of Part II of the WIA91.

² Sections 22A to 22F WIA91 were inserted by section 48(1) WA03. For present purposes, section 48(1) was brought into force on 1 April 2005 by the Water Act 2003 (Commencement No. 4, Transitional Provisions and Savings) Order 2005, SI 2005 No. 968, Article 2(i). Under Article 4 and Schedule 2, paragraph 4 of the Water Act 2003 (2003 (Commencement No. 4, Transitional Provisions and Savings) Order 2005, until the coming fully into force of section 36(1) WA03 (transfer to the Water Services Regulation Authority of functions, property etc) on 1 April 2006, any reference to the Water Services Regulation Authority in sections 22A to 22F WIA91 had effect as if it were a reference to the Director.

exercisable in respect of any contravention or failure before the commencement of section 22A, namely 1 April 2005³.

Ofwat may not impose a penalty in respect of a contravention or a failure later than twelve months from the time of the contravention or failure, unless before the end of that period notice under section 22A(4) WIA91 relating to the penalty is served on the undertaker under section 22A(8) WIA91.

A penalty may not exceed 10% of the company's turnover, determined in accordance with the Water Industry (Determination of Turnover for Penalties) Order 2005 (SI 2005 No. 477). That Order provides that the turnover of the company is the applicable turnover for the last business year preceding the date on which Ofwat gives notice under section 22A(4) WIA91 (i.e. the date of this notice). The applicable turnover is broadly the turnover derived from the company's regulated activities.

The 10% limit applies to each breach for which a penalty is imposed, rather than representing a cumulative limit for a financial year.

As required⁴, Ofwat has prepared and published jointly a Statement of Policy with the Secretary of State for the Environment, Food and Rural Affairs and the National Assembly for Wales with respect to the imposition of penalties and the determination of their amount (the "Statement of Policy")⁵. In deciding whether to impose a penalty, and in determining the amount of any penalty, Ofwat must have regard to the Statement of Policy most recently published at the time when the contravention or failure occurred.

³ The Water Act 2003 (Commencement No. 4, Transitional Provisions and Savings) Order 2005, SI 2005 No. 968, Article 2(i).

⁴ Section 22B WIA91, inserted by section 48 WA03. Section 22B WIA91 came into force on 1 October 2004: the Water Act 2003 (Commencement No 2, Transitional Provisions and Savings) Order 2004, SI 2004 No. 2528, Article 2(e)(ii).

⁵ "Statement of Policy with respect to financial penalties", 17 March 2005.

Penalties are paid into the Consolidated Fund and are not returned to customers⁶.

Ofwat shall not impose a penalty under section 22A WIA91 where it is satisfied that the most appropriate way of proceeding is under the Competition Act 1998. The matters with respect to which Ofwat proposes to impose a penalty relate to failures to achieve standards of performance under the GSS Regulations. Consequently, Ofwat is satisfied that it would not be appropriate to proceed under the Competition Act 1998.

The behaviour in respect of which Ofwat proposes to impose a penalty is the failure to achieve standards of performance prescribed under section 38(2) or 95(2) WIA91. Under those provisions the Secretary of State has the power to prescribe, by regulations, such standards of performance in connection with the provision of supplies of water or sewerage services as, in his opinion, ought to be achieved in individual cases. The GSS Regulations are made under those powers.

The GSS Regulations provide that if an undertaker fails to provide certain customer services in the manner set out, the undertaker must make a payment to that customer. The standards of performance prescribed by the GSS Regulations relate to:

- Keeping of appointments – including giving notice of the appointment to the customer and offering a time slot for the appointment (Regulation 3);
- Responding within a certain timeframe with a substantive reply to queries about the correctness of an account and requests about changing payment arrangements (Regulation 4);
- Responding within a certain timeframe with a substantive reply to written complaints from customers in connection with the supply of water or the provision of sewerage

⁶ Section 22A(9) WIA91.

services (Regulation 5);

- Interruptions to supply – including giving adequate notice of interruption and restoration of supplies (Regulation 6) and the length of time of an interruption to supply (Regulation 7);
- Maintaining adequate pressure (Regulation 7AA); and
- Flooding from sewers (Regulation 7B).

3. Background

On 7 April 2006, the Board of Severn Trent Plc (the parent company of Severn Trent Water) announced that it was providing Ofwat with an interim report into misreporting of customer relations data by Severn Trent Water to Ofwat. As a result of an ongoing review of Severn Trent Water by its managing director, Tony Wray, and his new management team, the Board of Severn Trent Plc believes there is prima facie evidence of customer relations data being misstated by Severn Trent Water in its submissions to Ofwat. The data concerns the handling of customer billing queries and telephone contacts over several years. This includes areas for which the GSS Regulations prescribe standards of performance.

As a result Ofwat and Severn Trent Water have jointly appointed Ernst & Young LLP to carry out an independent investigation into these irregularities. That investigation is ongoing.

In its announcement on 7 April, Severn Trent Plc gave an assurance that if customers had been disadvantaged they would be reimbursed. Ofwat has asked Severn Trent Water to provide a written undertaking that it will not benefit to the detriment of its customers from any irregularities found by the investigations. Consistent with this principle, the undertaking must state that Severn Trent Water will pay in full any amounts found by the investigation to be due to customers and that if Severn Trent Water benefited from the irregularities in terms of its price review, it will

fully adjust future prices to its customers. Ofwat has also asked Severn Trent Water to undertake that, in due course, it will provide Ofwat with a written statement that the company has adequate systems of control and internal planning to fulfil its functions and meet its obligations as an undertaker.

Ofwat has received such an undertaking in these terms in another similar case but Severn Trent Water has yet to provide Ofwat with such an undertaking, in addition to the general assurance given by Severn Trent Plc.

Ofwat expects Severn Trent Water to work to identify customers who did not receive a payment as required by the GSS Regulations. Severn Trent Water has agreed to set out for Ofwat's agreement how it intends to approach this. Severn Trent Water is also taking action to improve its customer service performance and the accuracy of the information it reports to Ofwat.

4. The failures

Under the time limits imposed by section 22C WIA91 Ofwat may not impose a penalty in respect of a contravention or failure prior to twelve months before the date of this notice.

This notice therefore relates only to Severn Trent Water's failure to achieve standards of performance prescribed by the GSS Regulations for the period from 9 June 2005 to the date of this notice.

Separately, Ofwat is considering whether Severn Trent Water has or may have contravened conditions of its appointment by providing Ofwat with information which is not reliable, accurate and complete in relation to its customer services and whether it would be appropriate to impose, or to propose to impose, a separate penalty or penalties in respect of any such contraventions. This notice is without prejudice to any penalty Ofwat may impose or propose to impose, or any other action Ofwat may take, in respect of any such contraventions.

From the evidence and information that Ofwat has seen to date, it is satisfied that Severn Trent Water has failed to achieve standards of performance prescribed in the GSS Regulations during the relevant period.

Whilst the company has provided Ofwat with some information about its levels of performance and the extent of its failures to comply with standards of performance prescribed by the GSS Regulations, that information is not yet complete. As stated above, Severn Trent Water is undertaking work to provide further information.

Examples of failures to comply with standards of performance prescribed by the GSS Regulations⁷

5.1 Standard of performance prescribed by Regulation 4 of the GSS

⁷ Reference should be made to the GSS Regulations for the complete wording of the GSS Regulations, including the exceptions to the prescribed standards of performance.

Regulations

Regulation 4 prescribes standards of performance in relation to account queries and requests about payment arrangements. It provides that, subject to certain exceptions:

- where a customer queries in writing the correctness of an account presented to him by an undertaker for the supply of water or sewerage services (“a query”), the undertaker must despatch a substantive reply to the customer within 10 working days from the date of receipt of the query; and
- where a customer asks in writing to change the arrangements by which he makes payments to the undertaker and that request cannot be met, the undertaker must despatch a substantive reply to the customer within five working days from the date of the receipt of the request.

If an undertaker fails to meet a standard of performance prescribed under Regulation 4, it must pay to the customer (or credit to his account) the sum of £20.

Section 22A(4) WIA91 requires this notice to set out the omissions which, in the opinion of Ofwat, constitute the failure in question. The evidence and information provided to date show that Severn Trent Water has failed to achieve the standards of performance set out above on a significant number of occasions during the period from 9 June 2005 to the date of this notice.

5.2 Standard of performance prescribed by Regulation 5 of the GSS Regulations

Regulation 5 prescribes standards of performance in relation to handling complaints about water or sewerage services. It provides that, subject to certain exceptions, where a customer complains in writing to a water undertaker in connection with the supply of water or to a sewerage undertaker in connection with the provision of sewerage services, the undertaker must despatch a substantive reply to the customer within 10 working days from the date of the receipt of the complaint.

If the undertaker fails to meet a standard of performance prescribed by Regulation 5, it must pay to the customer (or credit to his account) the sum of £20.

Section 22A(4) WIA91 requires this notice to set out the omissions which, in the opinion of Ofwat, constitute the failure in question. The evidence and information provided to date show that Severn Trent Water has failed to achieve the standards of performance set out above on a significant number of occasions during the period from 9 June 2005 to the date of this notice.

5. Facts justifying the imposition of a penalty

In deciding whether to impose a penalty in respect of a failure, Ofwat shall have regard to its Statement of Policy. The Statement of Policy states that when considering whether to impose a penalty, Ofwat will take account of the particular facts and circumstances of the case under consideration. This will include the extent to which the circumstances under which the failure arose were, or were not, outside the control of the company. It also states that when considering whether to impose a penalty, a penalty is more likely where:

- the contravention or failure has damaged the interests of 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.

On the basis of such evidence and information as has been provided to Ofwat to date, it appears to Ofwat that the failures arose under circumstances which were within the control of the company. Ofwat considers that customers' interests have been damaged, as the failures have meant that a significant number of Severn Trent Water's customers have not received the standards of performance in customer service prescribed by the GSS Regulations. Ofwat also considers that imposing a penalty would be likely to create an incentive to comply and deter future contraventions or failures on the part of Severn Trent Water and other undertakers.

The Statement of Policy states that a penalty will be less likely to be imposed where:

- the contravention or failure was or is of a trivial nature; or
- the contravention or possibility of a contravention would not have been apparent to a diligent company.

On the basis of such evidence and information as has been provided to Ofwat to date, it appears to Ofwat that the scale of the failures is not of a trivial nature and that the circumstances which lead to the failures should have been apparent to a diligent undertaker.

In the light of the above factors and on the basis that Ofwat is satisfied that Severn Trent Water has failed since 9 June 2005 to the date of this notice to achieve standards of performance prescribed in the GSS Regulations, Ofwat considers that it is appropriate to impose a penalty on Severn Trent Water in respect of its failure to achieve standards of performance under the GSS Regulations.

6. The amount of the penalty

Section 22B(2) WIA91 also states that in determining the amount of any penalty in respect of a failure Ofwat shall have regard to the Statement of Policy. The Statement of Policy sets out that any penalty must be reasonable in the circumstances of the case and that factors relevant to decisions on the broad level of a penalty will include:

- the seriousness and duration of the contravention or failure;
- the degree of nuisance, harm or increased cost incurred by customers, other market participants or the environment;
- any gain (financial or otherwise) made by the company 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.

On the basis of such evidence and information as has been provided to Ofwat to date, it appears to Ofwat that the failures are serious in nature. When Severn Trent Water has provided Ofwat with further information about (among other things) its performance from 9 June 2005 to the date of this notice in relation to the standards of performance prescribed by the GSS Regulations, Ofwat will be in a position to consider the factors needed to determine the broad level of the penalty and the aggravating and mitigating factors as set out in the Statement of Policy.

As required by section 22A(4)(a) and (c) WIA91 this notice must state the amount of the penalty proposed to be imposed and the other facts, which in the opinion of Ofwat, justify the amount of the penalty imposed. For the purposes of this notice only, the amount of the penalty is the nominal amount of £1. Until the required information referred to in the above paragraph has been provided, Ofwat is unable to quantify the final amount of the penalty.

7. Variation of this notice

As stated above, Ofwat requires Severn Trent Water to provide further information on (among other things) its failures to achieve the standards of performance prescribed by the GSS Regulations. It is likely that Ofwat will vary the proposal stated in this notice once the further information has been provided.

Ofwat has decided to issue this notice now, in order to take into account as many failures to achieve the standards of performance prescribed by the GSS Regulations as possible. Under the time limits imposed by section 22C WIA91 Ofwat may not impose a penalty in respect of a contravention or failure prior to twelve months

before the date of this notice. This notice therefore covers failures from 9 June 2005 to the date of this notice.

In the event that Ofwat wishes to vary this notice, in accordance with section 22A(5) WIA91, Ofwat will be required to give notice setting out the proposed variation and the reasons for it and to specify a period (of not less than twenty-one days) within which representations or objections with respect to the proposed variation may be made.

8. Representations or objections with respect to the proposed penalty

Under section 22A(4)(d) WIA91, Ofwat shall give notice specifying the period (of not less than twenty-one days from the date of publication of this notice) within which representations or objections with respect to the proposed penalty may be made. Accordingly, representations or objections with respect to the proposed penalty may be made by 5pm on 31 October 2006. Representations or objections should be made to Sue Cox, as set out below.

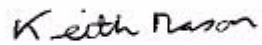
Sue Cox
Acting Head of Consumer Affairs
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Or by e-mail to sue.cox@ofwat.gsi.gov.uk

Any representations or objections, which should be made in writing, should be clearly marked 'Severn Trent Water Proposed Penalty'.

Representations and/or objections will be placed in our library and made available to the public, unless you have clearly indicated that you do not wish this to happen. In

general, we will honour this request, but there may be circumstances in which, under the Freedom of Information Act 2000, we would be obliged to disclose responses.

A handwritten signature in black ink that reads "Keith Mason". The signature is written in a cursive style.

Keith Mason
Director of Regulatory Finance and Competition
On behalf of the
Water Services Regulation Authority

With effect from 8 June 2006

ANNEX 2

Statement of policy with respect to financial penalties pursuant to section 22A of the Water Industry Act 1991

1. Background

- 1.1 The Water Industry Act 1991 (the Act), as amended by the Water Act 2003, provides that in certain circumstances an enforcement authority may impose a financial penalty on providers of water and sewerage services⁴. The penalties apply to the statutory undertakers appointed under Chapter 1 of Part 2 of the Act, that is the existing water and sewerage undertakers. They also apply to any company holding a licence under Chapter 1A of Part 2 of the Act (licensees). The relevant enforcement authorities are Ofwat⁵, the Secretary of State and the National Assembly for Wales (“the enforcement authorities”).
- 1.2 Any financial penalty collected is not returned to customers but is paid into the Consolidated Fund.
- 1.3 The Act requires each enforcement authority, having undertaken appropriate consultation, to prepare and publish a statement of policy that it will apply to the imposition of any penalty, and the determination of its amount⁶. This statement has been prepared in accordance with those requirements.
- 1.4 An enforcement authority may not impose a penalty where it is satisfied that the most appropriate way of proceeding is under the Competition Act 1998⁷. Each enforcement authority will take this into account throughout its procedures and deliberations.
- 1.5 The Act lays out procedures for notifying and consulting affected parties. In imposing any penalty, each enforcement authority will follow the procedural requirements set out in the Act⁸. The enforcement authorities will also consult each other and consider the views of interested parties, including WaterVoice and subsequently the Consumer Council for Water.

2. General approach

- 2.1 The primary purpose of the financial penalty system is to give companies an incentive to comply with statutory and regulatory requirements now and in the future. Penalties must be reasonable in the circumstances of the case and should also be such as to provide an adequate incentive both to the company in question and to other companies to comply.

⁴ Section 22A(1) and (2) of the Act.

⁵ The Director General of Water Services will be replaced by the Water Services Regulation Authority when section 36 of the Water Act 2003 is brought fully into force.

⁶ Section 22B of the Act.

⁷ Section 22A(13) of the Act.

⁸ Section 22A(4) to (10) of the Act.

- 2.2** In deciding whether to impose a penalty, each enforcement authority will take account of the particular facts and circumstances of the case under consideration. This will include the extent to which the circumstances under which the contravention or failure arose were, or were not, outside the control of the undertaker or licensee. The enforcement authority will also take account of any representations made by interested parties in response to a public notice setting out its proposals.
- 2.3** One enforcement authority will take lead responsibility for each case where a penalty may be imposed. Decisions on any particular case will not be reopened or revisited by another enforcement authority. This does not preclude notification and consultation from an early stage between enforcement authorities when a case is being considered. This will be normal practice.
- 2.4** A working group will be established to share information and, where concurrent powers exist between enforcement authorities, to agree which enforcement authority should take the lead in any case as it arises. Where there are concurrent powers to impose a penalty, our expectation is that Ofwat will take the lead. This group will also work to ensure consistency in decision making by different authorities.
- 2.5** In setting price limits for undertakers at a price review, Ofwat will exclude any direct costs associated with financial penalties imposed under section 22A, i.e. investors in the company will bear the full direct costs of the penalty.
- 2.6** Licensees are not subject to price limits set by Ofwat. However there is no incentive for a licensee to pass the cost of a financial penalty back to its customers, as this would make it less competitive. Customers might decide to switch supplier.
- 2.7** Where a penalty has been imposed on an undertaker this will be considered when price adjustments are made in relation to any other service related incentive mechanism such as Ofwat's overall performance assessment.
- 2.8** In considering any case in which a financial penalty might be imposed, the enforcement authority will need to address the following questions:
- Is it satisfied that:
 - i) the undertaker or licensee has contravened or is contravening any relevant condition of its appointment or licence; or
 - ii) the undertaker or licensee has contravened or is contravening any statutory or other requirement which is enforceable under section 18 of the Act; or
 - iii) the undertaker or licensee has contributed or is contributing to a contravention by another; or
 - iv) the undertaker has failed to achieve any standard of performance prescribed under section 38(2) or 95(2) of the Act?
 - If so, is it appropriate to impose a financial penalty?
 - If so, what amount is reasonable in the circumstances of the case?

3. Is a penalty appropriate and, if so, at what level?

- 3.1** Once satisfied that a contravention or failure of service has occurred or is occurring,

the enforcement authority will have to decide whether a financial penalty should be imposed and at what level.

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

- the contravention or failure has damaged the interests of 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.

3.3 A financial penalty will be less likely to be imposed where:

- the contravention or failure was or is of a trivial nature; or
- the contravention or possibility of a contravention would not have been apparent to a diligent undertaker or licensee;

To avoid double jeopardy a financial penalty will not be imposed where:

- the undertaker or licensee is being or has been prosecuted in respect of the failure or contravention, although a penalty might be appropriate in respect of different consequences of such a contravention or failure (e.g. for inadequate arrangements for communicating with customers in the event of an environmental or drinking water incident).

The enforcement authorities will also take into account any potential prosecutions and will liaise with outside bodies to determine who should take enforcement action.

The enforcement authorities will also take into account any potential prosecutions and will liaise with outside bodies to determine who should take enforcement action.

3.4 Once it has been decided that a penalty should be imposed the enforcement authority must consider the appropriate level. Any penalty must be reasonable in the circumstances of the case. Factors relevant to decisions on the broad level of a penalty will include:

- the seriousness and duration of the contravention or failure;
- the degree of nuisance, harm or increased cost incurred by customers, other market participants or the environment;
- any gain (financial 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.

3.5 There are a number of regulatory mechanisms already in place that give companies an incentive to comply with requirements: allowances in price limits based on the overall performance assessment (OPA) score; the logging down mechanism; the MD191 mechanism for underperformance in terms of cost overruns; and

compensation under the GSS scheme. The enforcement authorities will take these other mechanisms into account.

3.6 Having considered the broad level of penalty, other factors may be taken into consideration. Aggravating factors tending to lead to a higher penalty than otherwise may include, but would not necessarily be limited to:

- repeated contravention or failure;
- continuation of contravention or failure or making no attempts to rectify that contravention or failure after either becoming aware of the contravention or failure or becoming aware of the start of the enforcement authority's investigation;
- the involvement of senior management in any contravention or failure;
- the absence of any evidence of internal mechanisms or procedures intended to prevent contravention or failure;
- failure to compensate those affected; and
- any attempt to conceal the contravention or failure from the relevant enforcement authority and if so to what extent.

3.7 Mitigating factors tending to decrease the level of any penalty would include, but would not necessarily be limited to:

- the extent to which the undertaker or licensee had taken steps to avoid contraventions or failures, either specifically or by maintaining an appropriate compliance policy, with suitable management supervision;
- appropriate action to remedy the contravention or failure;
- evidence that the contravention or failure was genuinely accidental or inadvertent or outside management control;
- the extent to which the undertaker or licensee had compensated those affected;
- proactive reporting of the contravention or failure to the enforcement authority; and
- co-operation with any investigation.

3.8 Having considered, to the extent appropriate, the factors listed above and the circumstances of the case under consideration, the enforcement authority will determine the appropriate level of financial penalty. In doing so it will ensure that the amount it determines is not more than 10% of the turnover of the undertaker or licensee as required by the Act. The 10% limit applies to each breach for which a penalty is imposed, rather than representing a cumulative limit for a financial year. The definition and relevant period of turnover will be that set in an order made by the Secretary of State after consulting the National Assembly for Wales⁹.

⁹ Section 22A(11) of the Act.

3.9 We envisage that the maximum penalty would be applied only in the most severe cases.

4. Revision of the Statement of Policy

4.1 This statement was approved by the Secretary of State, the National Assembly for Wales and Ofwat and will take effect from 1 April 2005. Any future revisions will be subject to consultation and published in accordance with the Act¹⁰.

¹⁰ Section 22B(3) to (5) of the Act.