

Notice of Ofwat's 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(4) 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 contravened or is contravening any Condition of its Appointment;
- ii) On 8 June 2006 Ofwat served a Notice on Severn Trent Water Limited ("Severn Trent") under and in accordance with section 203(2) WIA91 (the "Section 203 Notice"):
 - (a) stating that it appeared to Ofwat that, when it submitted information on 10 June 2005, Severn Trent may have contravened Conditions of its Appointment (namely Condition J and/or Condition M in respect of regulatory reporting); and
 - (b) requiring Severn Trent to produce certain documents and to furnish certain information specified and described in that notice;
- iii) Ofwat has considered the facts, matters and circumstances relating to the contraventions. Ofwat has also considered the response of Severn Trent to the Section 203 Notice, as well as other relevant submissions and reports made by Severn Trent and other parties. Ofwat is:
 - (a) satisfied that Severn Trent contravened Condition J and/or Condition M of its Conditions of Appointment, when it submitted information on 10 June 2005. As well as data relating to 2004-05, the 2005 June return also included data relating to previous years, 2003-04, 2002-03 and 1997-98. At the time of submitting the 2005 June return, Severn Trent did not correct data relating to these three prior years;
 - (b) of the opinion that it would, in all the circumstances, be appropriate to impose a penalty on Severn Trent in respect of such contraventions.

NOW THEREFORE, OFWAT HEREBY GIVES NOTICE, UNDER AND IN ACCORDANCE WITH SECTION 22A(4) WIA91, TO ALL WHOM IT MAY

CONCERN THAT:

- i) For the reasons set out in the attached schedule: Ofwat has this day proposed to impose a penalty on Severn Trent in respect of Severn Trent's contravention of Condition J and/or Condition M of its Conditions of Appointment;
- ii) The penalty which Ofwat is proposing to impose is 2.9% of Severn Trent's turnover in 2006-07, which amounts to £34.7 million;
- iii) Any representations or objections with respect to the proposed penalty should be made to Ofwat in writing by no later than 5pm on 6 May 2008 and in accordance with the instructions set out in section 6 of the Schedule to this Notice.

Keith Mason

Director of Regulatory Finance and Competition

For and on behalf of the Water Services Regulation Authority

Dated this day, 7 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 comply with the Conditions of its Instrument of Appointment.
2. Conditions J and M of Severn Trent's Instrument of Appointment set out the requirements on it to furnish information or data (used synonymously in this Schedule) to Ofwat. Condition J concerns the annual reporting of levels of service information and Condition M sets out a more general obligation to provide information to Ofwat. These are included at Annex 1 to this schedule. Undertakers are required to furnish this information in an annual return known as the June return.
3. Ofwat's decisions are based on the information that undertakers furnish. Direct market competition in the regulated water and sewerage sectors is very limited. Ofwat therefore relies on its ability to make comparisons between undertakers to measure relative performance and put pressure on companies to perform as well as their peers when comparing costs and delivery of outputs. If the information provided by undertakers is not reliable, accurate and complete, Ofwat's ability to make comparisons is prejudiced.
4. Information furnished by an undertaker under Condition J and/or M – and in particular the information with which this Notice is concerned – can also have a direct impact on customers' bills. Companies can receive a benefit in price limits where their performance is judged to be at the leading edge of industry performance (in other words, Ofwat may permit those companies to raise charges to customers by a greater percentage than would otherwise be permitted). Severn Trent gained such a benefit.
5. When Severn Trent submitted its 2005 June return it deliberately misreported data about certain key customer service measures and misreported data under certain other customer service measures and its compliance with its statutory obligations under the Guaranteed Standards Scheme (the Water Supply and Sewerage Services (Customer Service Standard) Regulations 1989, SI 1989 No. 1159, (as amended) ("the GSS Regulations") due to failures in its systems and processes. The 2005 June return also included data relating to the three previous years, 2003-04, 2002-03 and

1997-98. At the time of submitting the 2005 June return, Severn Trent did not correct data relating to these three prior years which were also unreliable, inaccurate and incomplete.

6. Ofwat is satisfied that Severn Trent contravened the requirements of Conditions J and/or M of its Instrument of Appointment when it submitted its 2005 June Return. Due to the seriousness of the contravention, Ofwat is proposing to impose a significant penalty on Severn Trent.
7. This schedule sets out the acts and omissions which, in Ofwat's opinion, constitute the contravention in question and the other facts which, in Ofwat's opinion, justify the proposed penalty and its amount. Misreporting fundamentally prejudices the regulatory regime that Ofwat operates, which is based on comparative competition. A financial penalty is punitive in its nature and marks the seriousness with which Ofwat regards any misreporting of information.
8. The penalty Ofwat is proposing to impose on Severn Trent is 2.9% of Severn Trent's applicable turnover for the business year 2006-07. This amounts to £34.7 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 Notice, “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 Water Limited'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 Water Limited as a water and sewerage undertaker under sections 11 and 14 of the Water Act 1989 (now sections 6, 7, 11 and 12 of WIA91).
14. Severn Trent's appointment was and is subject to Conditions of Appointment imposed pursuant to section 11 WIA91. Those conditions are contained in Severn Trent's Instrument of Appointment. Severn Trent is obliged to comply with those Conditions of Appointment. Pursuant to Chapter II of Part 2 of WIA91, Ofwat has certain powers and duties in relation to undertakers' Conditions of Appointment.

2.3 Penalties

15. Under section 22A(1)(a) 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 contravened or is contravening any condition of its appointment.
16. Section 22A(9) WIA91 provides that penalties imposed under section 22A WIA91 must be paid into the Consolidated Fund.
17. 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, as provided by 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.
18. In the present case, a relevant notice under section 203(2) WIA91 was served by Ofwat on Severn Trent on 8 June 2006 (the "Section 203 Notice"). Accordingly, Ofwat cannot impose a penalty on Severn Trent in respect of any contravention of Condition J and/or M that occurred prior to 8 June 2005. This Notice deals with the contraventions that occurred on 10 June 2005, when Severn Trent submitted its 2005 June return.
19. In accordance with section 22B WIA91, Ofwat has prepared (jointly with the Secretary of State for 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.
20. 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).
21. 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 ...*"
22. 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;”

23. Ofwat considers that Severn Trent’s contraventions of Conditions J and/or M 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.
24. At the time of issuing this Notice, Severn Trent's last business year ran from 1 April 2007 to 31 March 2008. Accordingly, the maximum penalty Ofwat can impose for Severn Trent’s contravention in this case is 10% of applicable turnover in 2007-08. However, Ofwat has not yet received Severn Trent's accounts for that year. The turnover figures used in this Schedule therefore relate to Severn Trent's previous business year, which ran from 1 April 2006 to 31 March 2007. Ofwat considers that the possibility of exceeding the statutory ceiling of 10% of the 2007-08 turnover figure is extremely remote.
25. 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 Requirement on Severn Trent to furnish information

26. Under Section 22A(4) WIA91, Ofwat is required to set out the Condition(s) which has been contravened.
27. Severn Trent’s Conditions of Appointment set out the requirements on it to furnish information or data to Ofwat. Ofwat’s decisions are based on the information that undertakers furnish. Thus the information collected is fundamental to Ofwat in fulfilling its duties under section 2 WIA91.
28. Condition J concerns the annual reporting of levels of service information and Condition M sets out a more general obligation to provide information to Ofwat. At all material times, the Conditions of Severn Trent’s Appointment have included

Conditions J and M.

29. It is Ofwat's view, as set out in this Schedule, that by deliberately misreporting information relating to the quality of services provided to its customers in the 2005 June Return, Severn Trent has contravened Condition J and/or Condition M of its Conditions of Appointment.
30. In the remainder of this Schedule, references given in the format "Condition [letter] [number]" are references to paragraphs of the relevant Conditions of Appointment of Severn Trent's Instrument of Appointment. For example, Condition J1 refers to paragraph 1 of Condition J of Severn Trent's Instrument of Appointment.
31. For ease of reference, Ofwat here adopts the definitions used in Condition A3 of Severn Trent's Instrument of Appointment. .

2.5 Severn Trent's obligations under Condition J

32. Part 1 of Condition J (Condition J1 and J2) concerns levels of service information. By Condition J1.1 Severn Trent is required to furnish information to Ofwat once in each charging year which enables Ofwat to monitor and review the service that customers receive.
33. Conditions J2 and J7 impose various obligations in respect of certifying and verifying the information supplied in relation to levels of service and in respect of co-operation with Ofwat.
34. By Condition J2, Severn Trent is required, when furnishing information to Ofwat under Condition J1.1, also to provide a signed report, containing such information as Ofwat may specify as to the methods used, and as to the steps taken, by Severn Trent for the purpose of monitoring, assessing and reporting on levels of service (the Levels of Service Methodology Statement).
35. By Condition J7, annual reports on levels of service must be accompanied by a certificate, signed by the auditors or such other person as Ofwat may approve. Ofwat has approved the Reporter (usually an independent consulting engineer) to undertake this role. The certificate must state:

- whether, in the opinion of the person signing the certificate, the information furnished in the June return has been ascertained by the use of the methods and the taking of the steps which Severn Trent has informed Ofwat that it has used in the Levels of Service Methodology Statement; and
- whether, in the opinion of the person signing the certificate, the methods used and the steps taken are adequate for the purpose of ascertaining the information contained in the June return.

36. Under Condition J13, Severn Trent is required to publish information about its performance. The information furnished to Ofwat under Condition J is therefore intended not simply for Ofwat's own purposes, but also for dissemination to Severn Trent's customers and the wider public. Accordingly, Ofwat takes seriously any misreporting of that information, which is liable to mislead the public.

2.6 Severn Trent's obligations to furnish information under Condition M

37. By Condition M1, Severn Trent is subject to a general obligation to furnish information to Ofwat, which is in addition to the obligations specified in its other Conditions of Appointment.

38. By Condition M2, information required to be furnished under Condition M must be furnished in such form and manner and at such times as Ofwat may reasonably require. Further, that information must be accompanied or supplemented by such explanations as Ofwat may reasonably require Severn Trent to furnish.

39. Condition M3 requires Severn Trent to give, if Ofwat so requests, reasoned comments on the accuracy and text of any information or advice which Ofwat proposes to publish under section 201 WIA91. Severn Trent is, therefore, under an obligation to provide reasoned comments when Ofwat asks it to confirm the accuracy of data relating to Severn Trent to be published in Ofwat's annual report 'Levels of Service for the water industry in England and Wales' ("Levels of Service report"). This includes the Overall Performance Assessment score (the "OPA score") derived from that data. The OPA score covers a broad range of water supply, sewerage service, customer service and environmental performance and is important because it links price limits to standards of service. If Severn Trent confirms to Ofwat the

accuracy of the information to be published by Ofwat in the Levels of Service report but this is not accurate within the bounds specified, it will have breached Condition M3.

2.7 The GSS Regulations

40. Under sections 38(2) and 95(2) WIA91 the Secretary of State, may by regulations, prescribe such standards of performance in connection with the provision of supplies of water and sewerage services as in his opinion, ought to be achieved in individual cases.
41. The regulations made using those powers are referred to as the "GSS Regulations". The GSS Regulations prescribe minimum standards of performance in connection with the provision of water and sewerage services. The GSS Regulations were made as the Water Supply and Sewerage Services (Customer Service Standards) Regulations 1989, SI 1989 No. 1383, as amended by SI 1993 No. 500, SI 1996 No. 3065, SI 2000 No. 2301 and SI 2005 No. 2035¹.
42. The GSS Regulations provide that if an undertaker fails to provide certain customer services in the manner set out (a "GSS event" or "GSS failure"), the undertaker must make a payment to that customer (a "GSS payment"). The standards of performance prescribed by the GSS Regulations 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);

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.

- 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 adequate pressure (Regulation 7AA); and
- flooding from sewers (Regulation 7B).

2.8 The June return

43. Ofwat collects the information required by the Conditions of Appointment from undertakers as part of an annual return, known as the June return (or, prior to 1999, the July return; the term “June return” is used in this Schedule to refer to annual returns made in both June and July).

44. Since 1991, Ofwat has specified what information is to be furnished by means of its June Return Reporting Requirements and Definitions Manual (the “reporting requirements”). The reporting requirements cover specific data and supporting commentary. Undertakers are also required to assign ‘confidence grades’ to indicate the quality and reliability of the levels of service data submitted in the June return. Confidence grades have two parts: a reliability band, based on how the data was gathered; and an accuracy band, indicating its range of error.

45. No undertaker can be in doubt about the importance of providing Ofwat with high quality information. In the June return reporting requirements for 2001, for example, Ofwat explained:

“The Director attaches considerable importance to the establishment of a monitoring regime based on high quality data that has been subject to scrutiny. This requires the Company to install and maintain systems capable of providing the relevant information in an auditable form and for the continuing appointment of Reporters and Auditors to fulfil the roles identified in the Licence.”

“The June return is also one of the primary vehicles by which Ofwat fulfils its aim of making more information about the regulatory regime freely accessible to the general

public and other interested parties.”

46. For the avoidance of doubt, Ofwat considers high quality data to be that which is reliable, accurate and complete within the bounds specified.
47. As stated above, Condition J imposes an obligation on Severn Trent to furnish such information as Ofwat may specify regarding levels of service. Information on levels of service collected by Ofwat in the June return is therefore required under Condition J. Further, or alternatively, if and to the extent that any such information is not required to be furnished under Condition J, such information is required to be furnished to Ofwat under Condition M1.
48. By Condition M6, there is a presumption that any information supplied by Severn Trent in accordance with Condition J is sufficient for the relevant purposes of that Condition. In so far as the obligation to furnish the information required in the June returns is not specified in and/or does not fall within Condition J, however, the provision of that information falls under Condition M1, in which case Condition M6 is not relevant.
49. Severn Trent has therefore been required, at all material times, to furnish Ofwat with the information specified in its reporting requirements, primarily in the form of the June return.
50. For each June return submission undertakers are required not only to furnish information on the relevant reporting year but also to furnish information for “reference years”. In its 2005 June return, therefore, Severn Trent furnished information in respect of four years:
 - (i) the reporting year (i.e. 2004-05);
 - (ii) the two preceding reference years (Report Year -1, i.e. 2003-04, and Report Year -2, i.e. 2002-03); and
 - (iii) the Base Year (i.e. 1997-98).
51. Severn Trent’s obligation to provide robust information in its June return (including appropriate confidence guides) applies to information for every year reported on, even where such information has previously been submitted to Ofwat, as part of the

June return in earlier years.

52. Tables 2, 3, 3a, 4 and 5 of the June return collect information on key levels of service known as the DG Indicators. Performance against DG indicators allows Ofwat to monitor the levels of customer service provided by undertakers.
53. The relevant DG indicators are:
- DG2 – inadequate pressure
 - DG3 – supply interruptions
 - DG5 – flooding from sewers
 - DG6 – account queries received and responded to
 - DG7 – written complaints received and responded to
 - DG8 – bills for metered customers
 - DG9 – telephone call handling
54. Table 6 of the June return furnishes information on events where standards prescribed by the GSS Regulations are not met and the payments made to customers as a consequence, including confidence grades.

2.8.1 Regulatory action where performance is inadequate

55. Ofwat considers an undertaker's performance based on the information furnished in the June return. Where Ofwat believes performance is inadequate it may:
- (i) require further information from an undertaker;
 - (ii) require more frequent monitoring and an action plan to address the problem; and/or
 - (iii) take enforcement action against the undertaker.
56. Where Ofwat is satisfied that an undertaker has failed or is failing to achieve any standard set out in the GSS Regulations, it may impose a penalty under section 22A(1) WIA91. Ofwat has issued a separate Notice of its proposal to impose a penalty in respect of such failures by Severn Trent in the period from 9 June 2005 to 8 June 2006 (the "GSS Notice"). The proposal in this Notice is without prejudice to the proposal contained in that Notice.

2.8.2 Publication of customer service data

57. The detailed information that each undertaker furnishes in the June return is made available to the public. Each year Ofwat publishes a summary of the levels of service which each undertaker has achieved; any concerns Ofwat has and the action Ofwat has taken as a result.

58. Publication of undertakers' comparative level of service performance allows Ofwat, undertakers and consumers to see how each undertaker is performing and sets out, at an industry level, performance against the standards prescribed under the GSS Regulations. This also acts as an incentive for undertakers to improve the areas where their performance is comparatively poorer than that of other undertakers, or has deteriorated.

3. Facts and matters giving rise to the contravention of Condition J and/or Condition M

59. 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

60. 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".

61. 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.

62. In February 2006, Severn Trent informed Ofwat that it had deliberately misrepresented 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 Severn Trent's Customer Relations Department. The investigation covered performance against three 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) (see sections 2.7 and 2.8).

63. 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"). These

issues are considered in more detail in section 3.2 below.

64. In March 2006, Severn Trent agreed with Ofwat to extend its investigation into customer service performance 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.
65. 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 in Severn Trent’s investigation; to identify any areas where further investigation was required and, where agreed by Ofwat and Severn Trent, to undertake those further investigations and report on the findings.
66. 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.
67. Severn Trent submitted its final report (the “Severn Trent Report”) on the extended internal investigation to Ofwat on 10 July 2006. 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.
68. 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.
69. 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.

70. On 31 January 2007 Severn Trent submitted representations in response to the Section 22A(4) Notice (the “Section 22A(4) Response”). Severn Trent also responded to the Section 203 Notice (the “Section 203 Response”)
71. 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; 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.
72. 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.
73. 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.

3.2 The Ofwat Report and SFO Investigation

74. In March 2006 Ofwat published the Ofwat Report (available on Ofwat’s website www.ofwat.gov.uk). The Ofwat Report followed an investigation into allegations by

an employee of the provision of false information to Ofwat in order to secure more favourable outcomes at price reviews. During the course of the investigation Ofwat reported its concerns about the data on leakage to the Serious Fraud Office.

75. The Ofwat Report found that Severn Trent had:
- (i) Provided data to Ofwat that had been deliberately miscalculated and which meant customers had been overcharged;
 - (ii) Had poor internal processes and controls, which in the case of estimating and recording income led in Ofwat's view to price limits for the period 2005-10 that were higher than they should have been; and
 - (iii) Approached the collection and submission of data in a manner that caused Ofwat concerns.
76. The Ofwat Report covered the misstatement of the bad debt provision; calculation of the bad debt element of the company's interim determination of K (IDoK) application in 2002; the reporting of forecast revenue; and DG8 data.
77. On 22 November 2007 the Serious Fraud Office 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.
78. The nature of the failures considered in this Notice, including deliberate manipulation of data and deficiencies in processes and systems for reporting information, are similar to those identified in the Ofwat Report.
79. However, Ofwat is not proposing to impose a penalty for these contraventions and does not have the power to do so. If, however, Ofwat's powers to fine had existed prior to 1 April 2005, and Ofwat was able to take full account of these previous contraventions, the penalty proposed in this Notice would relate to a repeated contravention, and would therefore be considerably higher.

3.3 Evidence of failures to comply with Condition J and/or M

80. Ofwat has considered the following information in satisfying itself that Severn Trent has contravened Condition J and/or M of its Appointment, and in deciding whether to

impose a penalty and the amount of the penalty:

- (i) The Section 203 Response;
- (ii) The Section 22A(4) Response;
- (iii) The Severn Trent Report;
- (iv) The E&Y Report;
- (v) Data made available by Severn Trent in response to interim briefings by E&Y (the "Briefing Response").

81. In the following sections, Ofwat sets out the acts and omissions which, in Ofwat's opinion, constitute the contravention of Condition J and/or M by Severn Trent in respect of Tables 2, 4, 5 and 6 of the 2005 June return.

3.4 Deliberate misreporting of regulatory information

82. In respect of certain indicators Severn Trent's and E&Y's investigations found that Severn Trent knowingly reported information to Ofwat that did not reflect its actual performance. Severn Trent concluded that staff "were knowingly working in a way that was inconsistent with the published methodology. This allowed Severn Trent to present an overstated picture of its performance".

83. In its Section 203 Response Severn Trent stated that its investigation confirmed areas of deliberate misreporting in relation to DG6 and DG7. The E&Y Report, completed in January 2008, agreed with the overall findings of the Severn Trent investigation and confirmed that misreporting in these areas was "deliberate and misleading". In addition E&Y identified further misreporting in DG7 and DG9, and weaknesses in Severn Trent's processes which could have resulted in response times to written correspondence being misreported.

84. E&Y found that Severn Trent "actively sought to manipulate data to improve the reported position and that this was exacerbated by failures in the [Customer Relations Department] to comply with certain of [Severn Trent's] internal control procedures." E&Y also found that "the culture within the [Customer Relations Department] allowed increasingly serious misreporting to the Severn Trent Board, the Reporter and to Ofwat. This culture also meant that, although concerns were raised internally, they were disregarded".

3.4.1 Deliberate misreporting of data under the DG Indicators

85. The investigations by Severn Trent and E&Y identified evidence of various practices, adopted by the staff within the Customer Relations Department at Severn Trent, designed to manipulate and misreport data. The practices identified are set out below by each DG Indicator.

3.4.1.1 DG6 (Account queries)

86. As regards DG6:

- (i) Severn Trent measured DG6 performance by extrapolation of results from a sample of billing contacts. The Customer Relations Department manipulated the sample and presented an inaccurate picture in the June return. Severn Trent and E&Y found that selective sampling was undertaken to ensure that a target level of performance was achieved.
- (ii) Clear instructions were given to staff on how to select the sample to achieve the required level of compliance. In its investigation Severn Trent found evidence that staff were “knowingly working in a way that was inconsistent with the published methodology”.
- (iii) The practice of selective sampling was known to Severn Trent’s management at Head of Department level within the Customer Relations department and was accepted as Severn Trent’s way of operating.
- (iv) Standard non-substantive “holding letters” were issued in reply to customer queries and were incorrectly “classed as a substantive response and therefore treated as resolved for the purposes of DG6 measurement.”
- (v) Telephone billing enquiries reportable under DG6 were being declared complete at point of contact, even when the enquiry had been placed in a further queue.

87. Severn Trent’s published methodology for measuring its performance under DG6 did not reflect the process actually used by the company. For example, Severn Trent’s Level of Service Methodology Statement provided with its 2005 June return clearly states that the sample used as the basis of DG6 performance reporting is selected

on a random basis. Severn Trent's own investigation has clearly shown this was not the case and the sample was deliberately manipulated.

3.4.1.2 DG7 (Written complaints)

88. As regards DG7:

- (i) Severn Trent classified some written billing complaints as DG6 rather than DG7. This practice was known within Severn Trent Customer Relations Department as the "Telephone Cross procedure" (CROSS was an acronym used for an IT system within Severn Trent's Customer Relations Department). As a result of this deliberate misclassification, on most occasions customers did not receive a response to the complaint element in letters that contained both a billing enquiry and an element of complaint (generally about problems getting through to a Severn Trent telephone operator). In the Severn Trent Report, Severn Trent notes that: "From September 2001, [Severn Trent's] practice has been to place such letters in the [billing queries] process even if the letter contained a complaint." The Severn Trent Report also noted 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." Severn Trent's investigation found that only about 15% of the complaints handled through the "Telephone Cross procedure" were correctly answered.
- (ii) The "Telephone Cross procedure" resulted in an understatement of the DG7 position. During the period covered by this notice, the billing contact centre, where the highest volume of such letters is received, continued to designate complaints of this sort as general billing enquiries and omit them from the reported DG7 performance. This had the effect of reducing both the number of reported complaints and the overall time taken to respond to complaints. This practice (of designating complaints of this sort as general billing enquiries) had also been used in the operations contact centre, (a separate call centre within Severn Trent from the billing contact centre) but was discontinued in that call centre in 2002 when billing and operational contacts were split.
- (iii) Severn Trent staff were instructed not to follow the "Telephone Cross procedure" when the Reporter was present. When the Reporter was present, they classified even mild complaints properly as falling under DG7 (in

accordance with the stated methodology). This deliberately concealed the data manipulation from the Reporter and Ofwat.

89. Severn Trent's methodology for compilation of its DG7 performance (as submitted to Ofwat) did not reflect the processes it used in practice. For example, in its Levels of Service Methodology Statement provided with its 2005 June return, Severn Trent stated that any letter drawing attention to a level of service that a customer perceives to be below standard is regarded as a complaint even if written in mild and friendly terms. For the reasons set out above, that was not in fact the case.

3.4.1.3 DG9 (Telephone contact)

90. Severn Trent adopted practices which ensured that it reported a more favourable picture of performance than was actually the case. Severn Trent noted in its report that "there are a number of weaknesses in [Severn Trent's] practices that masked the true customer experience". Some of these practices are set out below:

- (i) In the 2005 June return, Severn Trent used a proxy measure to determine the reported number for 'all lines busy'. This estimated the number of customers receiving an engaged tone by dividing the total time lines were busy by a notional call time of two seconds. Ofwat reporting requirements in 2005 made it clear that this proxy measure should be used by "companies unable to measure the number of occasions when all lines are busy". E&Y found evidence which suggested that DG9 'all lines busy' performance could have been calculated by Severn Trent using the actual number of engaged calls rather than proxy data from 2002. Severn Trent used this proxy measure until 2006. In the Briefing Response, Severn Trent has restated DG9 performance for 'all lines busy' using this actual data. The effect (as set out in section 3.8 below) was that Severn Trent's reported performance was significantly better than its actual performance.
- (ii) E&Y also found evidence that "Severn Trent knowingly chose an inaccurate measure for 'all lines busy' which in all likelihood allowed for a lower number to be reported than if Severn Trent had counted the engaged tones on each line." The methodology used by Severn Trent to report "all lines busy" did not comply with the reporting requirements. Rather than reporting the total time that any one line was busy, the company grouped lines. If there was another line into the business available, then no 'all lines busy' event would be

reported despite customers hearing an engaged tone. Severn Trent continued to group telephone lines in its measurement of 'all lines busy' despite the change in Ofwat reporting requirements in 2002.

- (iii) Following a clarification in the Ofwat guidelines in 2001 about the point at which telephone response times should be measured, Severn Trent developed the concept of the 'meet and greet' team, which was employed to direct calls into the correct queue and not to answer customers' questions. The use of 'meet and greet' ensured that customers got through to a call agent within the 30 seconds period measured by DG9. Severn Trent took the view that the Ofwat guidelines allowed Severn Trent to declare a call as answered at the time the 'meet and greet' team picked up the call. This was based on the wording of the guidance that suggested that a call was deemed to be answered when it was picked up by an agent who was "able to answer the call." Severn Trent trained agents to be able to answer a call but ran a business process that then routed the caller to another agent. As a result the telephone response times were being reported at a point when the customer was still in a queue, and Severn Trent's process allowed it to present a more favourable picture of its performance than was in fact the case.
- (iv) Severn Trent's investigation found that it was "normal practice" to close down telephone lines whenever the queues ahead of the 'meet and greet' team were growing. This removed customers from potentially long queues, which could result in an abandoned call and presented the customer instead with an engaged tone. The number of abandoned calls was therefore artificially suppressed. This gave rise to more favourable performance measures under DG9 on response times and abandoned call rates.

3.4.2 Deliberate misreporting of information on GSS events and payments

- 91. Severn Trent's systems did not accurately record and report the occurrence of GSS events and the consequent requirement to make GSS payments. In practice Severn Trent adopted systems and practices designed to present a better picture of performance than was actually the case and these practices had an impact upon reported GSS information. The extent to which the information furnished was misreported has not, however, been fully established.
- 92. Both the Severn Trent and E&Y reports point out that deliberate actions taken by

staff to misreport information under the DG indicators had an impact upon the reporting of GSS events and payments. For example, for each misclassified “Telephone Cross” complaint that was responded to inappropriately a GSS event should have been recorded, since this constitutes a failure to meet GSS minimum standards.

93. Ofwat considers that the deliberate manipulation of statistics and the way in which Severn Trent interpreted Ofwat’s guidance in such a way that its performance appeared to be of a higher standard than was in fact the case, led directly to misreporting and underreporting of Severn Trent’s actual performance.

3.5 Failures and procedural weaknesses at Severn Trent

94. In addition to the deliberate actions taken to improve the reported position, the Severn Trent and E&Y reports found failings in processes and systems within the company which:

- (i) led to incomplete reporting under DG3 and the misreporting of data on supply interruptions;
- (ii) led to failure to capture information relating to GSS events and payments for GSS Regulation 3; and
- (iii) demonstrate poor controls over the handling of written customer correspondence under DG6 and DG7.

95. In the Severn Trent Report, Severn Trent acknowledges that its standards were not as high as they should have been and that it did not make use of the best information available. In addition, Severn Trent identified several areas of the company which required improvement with regard to its reporting methods and practices under DG2, DG3, DG5 and DG8. Problems included inadequate IT systems and E&Y found evidence of “a need for improvement in documentation”.

3.5.1 DG3 and supply interruptions

96. Although there is no evidence to suggest that DG3 data had been deliberately misreported, Severn Trent’s investigation identified that reporting under DG3 was incomplete. Data relating to overruns of planned interruptions for mains rehabilitation

and renewals had not been included in the reported DG3 performance since 2000. This was as a direct result of a company reorganisation and the team within Severn Trent with responsibility for DG3 reporting at that time failed to recognise that this data needed to be fed into the reporting process. Severn Trent's investigation found that "a lack of reporting procedures within [Severn Trent's] Engineering department meant that its reported DG3 performance data was not complete."

97. The omission of data from events reported in relation to supply interruptions has a small impact on overall DG3 performance, which is consistent with the confidence grades assigned by Severn Trent. However, E&Y calculated that reported performance for overruns of planned interruptions (as reported in Table 2 of the June return) was significantly affected by the failures in Severn Trent's system and processes. The extent of the misreporting in this area is set out in section 3.8.3 below.

3.5.2 GSS events and payment data under GSS Regulation 3

98. In relation to GSS Regulation 3 (making and keeping appointments), 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." As a consequence, Severn Trent's reported performance under GSS Regulation 3 is unlikely to have been complete or accurate.

3.5.3 Written customer correspondence

99. E&Y looked at DG procedures at Severn Trent's main post processing centre. E&Y noted a number of areas which could give rise to misreporting issues, including:
- (i) E&Y found that written responses to customer billing enquiries and customer complaints processed at the weekend were "recorded as resolved on a Friday even though they [were] not dispatched until the following Monday. This under-records the number of days between receipt and dispatch."
 - (ii) E&Y also found evidence of "date fields relevant to DG reporting being changed without audit trail".

100. It is not possible to quantify the effect of these practices on the reported numbers for DG6 and DG7, and accordingly are not considered in Ofwat's assessment of the extent of the misreporting in section 3.8. However, Ofwat considers that these practices are relevant to the consideration of a financial penalty, as they demonstrate that Severn Trent did not have the controls over the quality of its data that are expected of a diligent undertaker.

3.6 Confidence grades

101. Ofwat requires undertakers to assess the quality of the data they report in the June return by using a system of confidence grades. This allows Ofwat to compare the quality of the data it receives from undertakers. Ofwat sets out how to assign confidence grades in the reporting requirements it provides to undertakers. Ofwat also publishes certain of the confidence grades reported by undertakers. Ofwat requires undertakers to submit confidence grades that accurately represent the quality, reliability and accuracy of the data to which they are assigned.

102. Confidence grades have two parts:

- (i) a reliability band based on how the data was gathered; and
- (ii) an accuracy band indicating its likely range of error.

103. The reliability and accuracy bands are set out in Table 1 below.

Table 1: Reliability and accuracy bands for confidence grades

Data reliability bands	
A	Sound textual records, procedures, investigations or analysis properly documented and recognised as the best method of assessment.
B	As A, but with minor shortcomings. Examples include old assessment, some missing documentation, some reliance on unconfirmed reports, or some use of extrapolation.
C	Extrapolation from limited samples for which grade A or B data is available.
D	Unconfirmed verbal reports, cursory inspections or analysis.

Accuracy bands	
1	±1%
2	±5%
3	±10%
4	±25%
5	±50%
6	±100%
X	For very small numbers where accuracy cannot be calculated or the error could be more than ±100%

104. Severn Trent assigned high confidence grades to the misreported data at the time of the 2005 June return. For example, Severn Trent reported a confidence grade of A2 in the 2005 June return for 2004-05 data on DG6, DG7, DG9 and GSS data on appointments, written billing queries and written complaints. Where Severn Trent deliberately misreported data, the confidence grades assigned to that data are necessarily meaningless (since the data was known to be both incorrect and unreliable). Deliberate misreporting fundamentally undermines the checks and balances inherent in the confidence grade system. Although this would be the case for any confidence grade assigned to the deliberately misreported data, Ofwat considers it noteworthy that Severn Trent assigned high-quality confidence grades, which helped to maintain the false picture of high-quality service to its customers.
105. Severn Trent also assigned high reliability to the confidence grade assigned to misreported data on supply interruptions; all the relevant data was assigned an A3 confidence grade. The extent of the misreporting and the systemic weaknesses which contributed to that misreporting demonstrate that the confidence grades assigned to this data were inappropriate. In its 2007 June Return Severn Trent assigned confidence grades of B2 to DG6 and DG7, either a B2 or B3 to its DG9 data and either a B3, B4 or BX grade to its GSS data.

3.7 Corporate governance and corporate culture

106. Ofwat considers that Severn Trent neglected its obligations in respect of the provision of reliable, accurate and complete data and had systems of internal control which were inadequate to ensure that the data reported was robust or to identify the

misreporting. In Ofwat's view the level of corporate governance within Severn Trent was not sufficiently robust to identify and rectify the manipulation and concealment of customer service performance issues within the Customer Relations Department.

107. The use of false data and omissions of important facts appear to have become routine practice within the Customer Relations Department.

108. In its Section 203 Response, Severn Trent states that "The Board of Severn Trent Water relies on the Regulation department to implement adequate processes and controls" around the reporting of regulatory information. Severn Trent identified a number of weaknesses in its processes as follows:

"...

- Procedures were not formalised;
- Ownership and responsibilities were not clear and documented;
- Revised methodologies were not tracked through a controlled process;
- Revised methodologies were not formally approved;
- There was no formal sign off of the data by Senior Management;
- In the case of DG6 and DG7 the company methodology was not followed;
- and
- The process of self audit was not carried out.

..."

109. In addition, the Board of Severn Trent does not appear to have taken any collective responsibility for ensuring the robustness of the information reported to Ofwat.

110. E&Y found that Severn Trent's Customer Relations Department had failed "to comply with certain of Severn Trent's internal control procedures", thus exacerbating the misreporting problem.

111. E&Y note that "practices which resulted in the misreporting were repeatedly discussed by and documented in papers circulated to the Senior Management team" in the Customer Relations Department.

112. Both the Severn Trent and the E&Y investigations identified instances where employees expressed concerns about being instructed to manipulate data

deliberately and about internal control systems and practices. Although these concerns were expressed clearly and specifically there was no change to the practices which had led to the misreporting. Furthermore, staff did not choose to raise concerns using Severn Trent's whistleblower policy, instead raising concerns only with internal line managers. Although those concerns were then raised with the senior management team within the department, no further action was taken.

113. E&Y states that "Neither [Severn Trent's] nor [E&Y's] investigation identified a conclusive reason as to why individuals chose to misreport performance data". In its Section 203 Response Severn Trent noted that a review of statements given by current and previous members of staff suggest a number of reasons why and how the misreporting continued within the Customer Relations Department. These include:

"...

- An endorsement of the misreporting by [managers within the Customers Relations Department] and a lack of willingness among [managers] to address the issue;
- A culture among [managers] of only 'reporting good news' up to Director level;
- A desire among [managers] to mask poor performance, particularly of the billing contact centre;
- A desire among [managers] to mask backlogs caused by the implementation of the new billing system introduced in 2004.
- A desire among [managers] to report high levels of performance in relation to DG measures and to present Severn Trent as an exemplar in the area of customer service; and
- Managers in Customer Relations had targets for DG6, DG7, DG8 and DG9 performance built into their base bonus targets for remuneration.

..."

114. Severn Trent has recognised the need for increased openness and a change in its corporate culture. E&Y notes that Severn Trent has taken steps to "implement a change in corporate culture" and "in particular to increase openness within the business".

3.8 Extent of the misreporting

115. Severn Trent has undertaken an exercise in order to establish the extent of its misreporting in the June return 2005. Severn Trent has restated data for performance under the DG6 and 7 indicators and restated some data relating to GSS events and payments. Severn Trent's review of reporting resulted in substantial reductions in reported performance and demonstrates the extent of the misreporting. As part of its investigation E&Y has reviewed Severn Trent's restatement of reported data for the three year period from 2002-03 to 2004-05.
116. Ofwat is satisfied that even these restated figures for information under DG indicators understate the true extent of the misreporting. E&Y reviewed Severn Trent's approach to the restatement of data and found that Severn Trent's sample for the restated DG6 performance for the three year period from 2002-03 to 2004-05 did not include telephone contacts deemed resolved at point of contact. E&Y stated that "extending the sample testing to these contacts would in all probability have resulted in the restated DG6 performance being lower" than calculated by Severn Trent.
117. Regarding Severn Trent's calculation of missed GSS payments relating to billing queries, E&Y stated that Severn Trent's exercise had two key limitations. First because Severn Trent has estimated the GSS failures under Regulation 4 by extrapolating from the results of a small sample of contacts (600 contacts per year were tested), the extrapolated total of 12,119 may not have been representative of the actual number of missed GSS payments over the period. Secondly by extrapolating the results, Severn Trent has been unable to identify the actual number of customers who may have been entitled to GSS payments.
118. The original but manipulated figures provided in June return 2005 positioned Severn Trent as a good performer. By contrast, the restated figures clearly indicate that Severn Trent's performance for DG6 and DG7 was well below the industry average performance, despite the shortcomings of the quantification exercise

3.8.1 DG6 and DG7

119. The original statement and restatement of DG6 and DG7 are set out in Table 2 below.

Table 2: Information under DG6 and DG7 as reported in the June Return 2005 and as restated in Severn Trent's Section 203 response

	1997-8		2002-03		2003-04		2004-05	
	JR05	S203	JR05	S203	JR05	S203	JR05	S203
DG6								
Percentage billing queries dealt with within 5 working days	96.34%	93.20%	99.96%	85.90%	99.98%	87.50%	99.55%	85.70%
DG7								
% Written complaints dealt with within 10 working days	98.81%	98.81%	99.98%	95.20%	100.00%	95.60%	100.00%	94.60%

120. As shown in Table 2, Severn Trent's reported performance in respect of DG6 and DG7 clearly presented a more favourable picture of performance than was actually the case. For DG6, the reported June return figures showed a picture of improving performance, whereas performance had in fact deteriorated since the reference year 1997-98. The industry average reported for 2004-05 for DG6 was 95.5%; Severn Trent's actual performance was well below this.

121. For DG7, Table 2 shows that actual performance has again deteriorated since the reference year (in contrast to reported performance which showed an improving trend). Actual performance was also well below both the 100% compliance reported in the 2005 June return and the industry average of 99.7%.

3.8.2 DG9

122. Severn Trent stated in its Section 203 Response that there was no misreporting under DG9 in its June return 2005, however this was not actually the case. E&Y found evidence that Severn Trent's method, "in all likelihood allowed for a lower number [for 'all lines busy'] to be reported than would have been the case". E&Y concluded that as a result of Severn Trent's practices the "reported number of calls

receiving an engaged tone was understated”.

123. In the Briefing Response, Severn Trent provided a summary table which compared the ‘all lines busy’ data reported in the 2005 June Return with the actual number of calls receiving an engaged tone (which Severn Trent could and should have reported in 2005). This comparison is set out in Table 3 below. Table 3 does not include 1997-98 data as the investigation found that issues with DG9 began when reporting requirements changed in 2001-02.

Table 3: Information under DG9 as reported in the June Return 2005 and as restated in the Briefing Response

	2002-03		2003-04		2004-05	
	JR05	Restated	JR05	Restated	JR05	Restated
‘all lines busy’	9,780	109,528	12,906	70,662	11,089	272,775

124. It is clear from Table 3 that performance against the ‘all lines busy’ measure reported by Severn Trent in the 2005 June return was not reflective of the underlying performance. The actual number of customers receiving an engaged tone in the 2004-05 reporting year was almost 25 times higher than that reported.

3.8.3 Supply interruptions

125. The original data relating to overruns of planned interruptions (as reported in Table 2 of the 2005 June return), and E&Y’s restatement of them are set out in Table 4. Table 4 does not include 1997-98 data as the investigation found the issue identified in relation to DG3 is likely to have begun in 2000.

Table 4: Supply interruptions data as reported in Table 2 of the 2005 June return and as recalculated by E&Y

	2002-03		2003-04		2004-05	
	JR05	E&Y	JR05	E&Y	JR05	E&Y
Unplanned interruptions (overruns of planned interruptions)						
>6 hours	2,395	11,596	1,611	9,981	519	4,199
>12 hours	1,971	6,513	1,152	5,284	50	1,867
>24 hours	77	388	9	292	0	125

126. Table 4 clearly demonstrates that Severn Trent significantly underreported the true incidence of overruns of planned interruptions; actual performance was significantly worse than reported performance in all cases.

3.8.4 GSS events and payments data

127. In Table 6 of its 2005 June return, Severn Trent also underreported the number of GSS events which occurred. To assess the extent of misreporting, Severn Trent used a random sample to recalculate performance figures for DG6 and GSS Regulation 4 (response to written account queries) for 2002-03, 2003-04 and 2004-05. 1997-98 data was not reassessed by Severn Trent due to the cost and time taken to complete the exercise. It found that 12,119 responses to written contacts were not made within the required timescale. This compares to the reported figure of 7 GSS events during the relevant period.

128. Through an analysis of "Telephone Cross" complaints and a recalculation of performance figures for DG7 and GSS Regulation 5 (response to written complaints), Severn Trent determined that a total of 3,363 GSS events should have been reported for 2002-03, 2003-04 and 2004-05; Severn Trent actually reported just 5 (including none in either 2003-04 and 2004-05, when in fact over 1,000 occurred in each year).

Table 5: GSS events data as reported in Table 6 of the 2005 June return and as restated by Severn Trent

	2002-03		2003-04		2004-05	
	JR05	Restated	JR05	Restated	JR05	Restated
GSS – Written account queries						
Number not dealt with within GSS period	2	7,134	5	1,926	0	3,059
GSS – Written complaints						
Responses exceeding GSS period	5	1,160	0	1,006	0	1,197

129. It is clear from Table 5 that Severn Trent significantly underreported (by several orders of magnitude) the number of GSS events which occurred in respect of GSS Regulations 4 and 5.

3.9 Contravention of Conditions J and/or M – Levels of service information

130. Severn Trent deliberately misreported and manipulated its performance statistics to present a better picture of customer service performance than actually existed. Ofwat is consequently of the opinion that Severn Trent has contravened Condition J and/or M in failing to ensure that the information in the 2005 June return was reliable, accurate and complete, within the bounds that it specified at the time that it furnished the information.

131. Further, Ofwat is of the opinion that Severn Trent materially misstated the service it had actually been providing to its customers by deliberately adopting interpretations of Ofwat’s guidance and practices to compile data relating to the DG indicators in the June return that allowed it to report better performance than was actually the case. Accordingly Ofwat considers that Severn Trent has contravened Condition J. The misreported data had a direct impact on price limits (see section 4.1). In addition, Severn Trent contravened Condition M3 by failing to alert Ofwat to incorrect data

used in the OPA when asked to provide reasoned comments on that data.

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

132. Under section 22A(4) WIA91, Ofwat is required to specify the "other facts" which, in the opinion of Ofwat, justify the imposition of the penalty.
133. Ofwat is satisfied that Severn Trent contravened Conditions J and/or M of its Conditions of Appointment when it submitted its 2005 June return on 10 June 2005. In determining whether 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

134. Ofwat relies on the regulatory information that undertakers are required to furnish under Conditions J and M in order to fulfil its statutory duties under section 2 WIA91. Ofwat uses this information to protect the interests of consumers, to secure that the functions of water and sewerage undertakers are properly carried out and to secure that undertakers are able to finance their functions. Ofwat collects and publishes data across all aspects of regulated companies' performance.
135. Ofwat regulates a monopoly industry using comparative competition. This is a key element in the regulatory system for the water and sewerage industries, recognised by a specific legal framework. Direct market competition in the regulated water and sewerage sectors is very limited; water and sewerage companies are largely monopoly businesses, and the vast majority of their customers, including all of their domestic customers, cannot choose to switch to a different supplier. Ofwat therefore relies on its ability to make comparisons to measure relative performance in order to mimic market competition. This puts pressure on companies to perform as well as their peers when comparing costs and delivery of outputs. Under section 70 of, and Schedule 6 to, the Enterprise Act 2002 the test the Competition Commission applies in considering a merger of undertakers is "whether that merger may be expected to prejudice the ability of [Ofwat] in carrying out its functions by virtue of the [WIA91] to make comparisons between different water enterprises". This recognises that comparisons between undertakers play a critical role in Ofwat's regulation of the

industry, including determining price limits. Fundamental to this is good quality data. Inaccurate and/or unreliable information prevents valid comparisons and prejudices the regulatory system. The result of this is that the protection Ofwat can give consumers is affected detrimentally.

136. Where misreporting, whether this is deliberate or not, masks inadequacies in an undertaker's performance or a company conceals its failure to comply with required service standards, Ofwat is prevented from identifying failures in the service that customers receive, from taking action in respect of the failures that have occurred and from remedying the problem going forward. Undertakers may avoid the need for expenditure to remedy the situation and benefit in price limits to the detriment of their customers. In this instance, Severn Trent's misreporting of performance, both that which was deliberate and that which was a result of weaknesses in its systems and processes, meant that customers continued to receive a level of service which was well below both the industry average and the level that Ofwat considers acceptable.
137. Information furnished by an undertaker under Condition J and/or M – and in particular the information with which this Notice is concerned – can have a direct link to prices charged to customers. Companies can receive a benefit in price limits where their performance is judged to be at the leading edge of industry performance (in other words, Ofwat may permit those companies to raise charges to customers by a greater percentage than would otherwise be permitted). Equally, where a company's performance is poor it can be penalised in price limits (in other words, Ofwat may only permit those companies to change charges to customers by a lower percentage than would otherwise be permitted). These adjustments are made through the OPA mechanism.
138. At the 2004 price review Severn Trent benefited through an adjustment made to price limits which was partly based on customer service data that was misreported both deliberately and as a result of weaknesses in systems and processes. Information for the years 2002-03 and 2003-04 fed directly into the positive OPA adjustment made for Severn Trent at the price review in 2004. Had Severn Trent reported its performance accurately, it would not have received this adjustment. The misreported customer service information was furnished to Ofwat in the 2003 and 2004 June returns and was furnished to Ofwat again in the 2005 June return. By continuing to misrepresent its performance in the June return 2005, Severn Trent continued to

benefit from an OPA adjustment to which it was not entitled, and to charge its customers' higher prices than they should have paid. There are mechanisms available by which undertakers can correct information, for prior years, that is included in the June returns. Had Severn Trent provided details of its actual performance in its June return for earlier years, Ofwat could have taken action at an earlier stage to prevent customers from paying bills that were higher than they should have been.

139. The information collected by Ofwat is, unless commercially sensitive, generally published. The information is used by other regulators and by CCWater in fulfilling its statutory duties, by undertakers to benchmark their own performance and by customers to hold the water and sewerage undertakers to account.
140. Misreporting undermines the confidence of customers and other stakeholders in the ability of undertakers to fulfil their functions and obligations. Where a company deliberately takes action to conceal its true performance and to misrepresent its performance to third parties, the impact of such misreporting increases significantly, and it seriously damages the integrity of the regulatory regime. Misreporting of any kind leads to reduced confidence in the regulatory regime, in Ofwat's ability to intervene to protect customers' interests and in the value of published information to those who use it. Misreporting also risks damage to the reputation of those undertakers who have not misreported. Press coverage, customer correspondence and public statements by CCWater indicate that customers' confidence in the industry as a whole has been damaged by misreporting of data, and particularly by cases where companies have knowingly presented falsified information.
141. Misreporting can also adversely affect other undertakers more directly. In making use of comparative competition, Ofwat makes judgements about the performance of specific undertakers relative to the performance of other undertakers. When an undertaker misrepresents its performance, other undertakers may be required to meet more stringent targets for improvements or appear to be performing less well, relative to others, than is actually the case.
142. Ofwat may also deem it necessary to seek additional quality assurance measures from undertakers to confirm the reliability, accuracy and completeness of data. For example, Ofwat set out its requirement on undertakers to complete additional quality

assurance checks of compliance with the GSS Regulations in MD220 “Review of companies’ systems, procedures and controls for compliance with the GSS regulations and reporting of customer service data in the June return”.

143. Ofwat considers that Severn Trent’s contraventions of Condition J and/or Condition M have undermined Ofwat’s ability to perform its statutory functions, and damaged the interests of both customers and other market participants.

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

144. In a largely monopoly industry where the majority of customers cannot change suppliers, high quality regulatory information is fundamental to Ofwat’s role in protecting customers. Strong incentives to discourage misreporting and manipulation of data and to encourage robust procedures are therefore essential. Ofwat’s Statement of Policy states that “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.”

145. Ofwat considers that applying a penalty in this case gives a proportionate and adequate incentive for Severn Trent and other undertakers to ensure the reliability, accuracy and completeness of the information they are required to furnish to Ofwat, now and in the future.

146. Ofwat notes that Severn Trent has incurred costs in the course of investigating, quantifying, and remedying the deficiencies in its systems and the non-compliant practices which led to the misreporting. Ofwat does not consider that these costs are sufficient deterrent against similar future contraventions, for the following reasons:

- (i) The possibility of future costs to remedy non-compliance did not deter Severn Trent in this instance. Accordingly, Ofwat does not consider that the putative cost of remedying contraventions at some unspecified future date will deter Severn Trent or other undertakers from similar failures in the future.
- (ii) The costs which Severn Trent has incurred and is incurring in order to remedy

its contraventions are costs which it should have incurred in order to ensure that its performance was reported to the standard which Ofwat expects of a diligent undertaker.

147. Ofwat also accepts that Severn Trent voluntarily reported its failures to Ofwat, and cooperated with the independent investigation. However, Ofwat does not consider that a company that reports its wrongdoing to the regulator should thereby be absolved of accountability for that wrongdoing, or that a contravention as serious as deliberate misreporting, can be remedied by co-operation. Ofwat's Statement of Policy provides for mitigation of the amount of a penalty where a company has pro-actively reported, cooperated with an investigation and taken appropriate action. The Statement of Policy does not provide that such action will wholly negate the need for a penalty.
148. In a monopoly industry where very few customers can change suppliers, high quality regulatory information is fundamental to Ofwat's role in protecting customers. Ofwat considers that a penalty in this case will make clear to Severn Trent and to other companies the importance of furnishing reliable, accurate and complete data to Ofwat and of having robust systems and sufficient controls in place and will deter misreporting and falsification of data.
149. Ofwat also considers that a penalty in this case will be an incentive on Severn Trent to comply in future. Severn Trent has been subject to a previous Ofwat investigation and the investigation in this case has identified that the culture within the company that facilitated misreporting in the earlier case also contributed to the misreporting in this case. Whilst Ofwat cannot impose a penalty for the practices highlighted by this previous investigation it is Ofwat's view that a penalty is necessary in this case to deter Severn Trent from allowing a similar situation to arise in future.

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

150. Ofwat considers that the deliberate manipulation and misreporting of customer service and GSS information in the 2005 June return by Severn Trent is not a trivial issue. Severn Trent overstated its level of performance and knowingly presented a

false picture of the way in which it dealt with its customers. It also significantly overstated the confidence grades associated with that data. Ofwat views this as a serious contravention which merits serious consequences.

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

151. The care with which Ofwat defines and develops its information requirements should be evident to undertakers from the terms of Conditions J and M. The requirements in each undertaker's Conditions of Appointment for information to be reviewed and reported on by an independent reporter are such that each undertaker needs to establish effective quality assurance systems for regulatory information. Undertakers were reminded of their obligations to provide reliable, accurate and complete regulatory information when Ofwat published MD209, "Reliability of regulatory information", on 4 November 2005.
152. As set out in section 3, the actions identified by the Severn Trent and E&Y investigations that led to the misreporting, both deliberate and as a result of weaknesses in systems and processes, were not the actions of a company acting with due diligence. Had sufficient controls been in place, the manipulation and misreporting would have been more difficult to establish and maintain and may have been discovered earlier or not occurred at all. Ofwat considers that Severn Trent did not behave as a diligent undertaker as it neglected its obligation to ensure reported data was reliable, accurate and complete, and failed to maintain and operate adequate systems and processes to ensure it met its obligations.
153. The extent of the investigation into data and systems that has been necessary in order to establish actual performance demonstrates the extent of the manipulation and misreporting and the inadequacy of the systems in place at the company to control data quality and monitor and measure its actual performance.
154. The established regulatory system includes independent challenge and certification of undertakers' level of service information by the Reporter and allows undertakers to give an indication of data quality through the use of confidence grades. However, this system of independent challenge does not absolve undertakers from their obligations in respect of the provision of information and the integrity of that

information or reduce those obligations in any way. The undertaker is responsible for providing full access to primary data and for communicating any concerns over data quality to its Reporter and to Ofwat. For example the investigation found that when the Reporter was visiting, a different approach to “Telephone Cross” calls was taken. Ofwat has therefore concluded that Severn Trent deliberately sought to mislead the Reporter about the service it was providing to its customers.

155. Severn Trent remains ultimately responsible for the integrity of the information it submits, the systems from which it derives that information and its processes for doing so and for securing that it has met its obligations.
156. Accordingly, Ofwat considers that Severn Trent did not act in a diligent manner to ensure that rigorous checks on data and the processes used to generate the data were carried out. As such, Severn Trent did not ensure that it had in place an environment or culture in which deliberate misreporting was made difficult and/or could be readily discovered or was considered by staff to be inappropriate in principle.

4.3 Double jeopardy

157. Ofwat is not aware of any prosecution which has been instigated or has been proposed in respect of the contravention of Conditions J and/or M of Severn Trent’s Conditions of Appointment.

4.4 Appropriateness of a penalty in this case

158. For the following reasons, Ofwat considers that the imposition of a financial penalty is justified in the present case:
- (i) Severn Trent overstated its true performance over a range of measures;
 - (ii) Severn Trent’s misreporting, both deliberate and that which occurred as a result of weaknesses in systems and processes, disguised its poor service relative to other companies;
 - (iii) Severn Trent’s misreporting, both deliberate and that which occurred as a result of weaknesses in systems and processes, has seriously prejudiced the regulatory regime (which relies on comparisons between undertakers to

mimic competition). This has compromised Ofwat's ability to regulate both Severn Trent and the wider industry, and has damaged the interests of all customers and all other market participants;

- (iv) Severn Trent's misreporting has directly disadvantaged its customers as it enabled Severn Trent to escape scrutiny, continue providing poor service and to continue charging prices which were higher than they should have been;
- (v) Ofwat considers that misreporting, and particularly deliberate misreporting, of regulatory information is a serious contravention with serious consequences. Deliberate misreporting is completely unacceptable and is well below the standards that Ofwat requires in an undertaker acting with due diligence ; and
- (vi) a deterrent against non-compliance by either Severn Trent or other companies is appropriate.

5. Assessment of the amount of the penalty which Ofwat is proposing to impose

159. 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.
160. 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, and has considered the matters set out in the following paragraphs.

5.1 The maximum possible penalty under section 22A WIA91

161. 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 (see section 3 above).
162. At the time of issuing this Notice, Severn Trent's last business year ran from 1 April 2007 to 31 March 2008. However, Ofwat has not yet received Severn Trent's accounts for that year. Accordingly, the turnover figures used in this Schedule relate to Severn Trent's previous business year, which ran from 1 April 2006 to 31 March 2007. Severn Trent's applicable turnover derived from its activities as both a water and a sewerage undertaker in the 2006-07 business year was £1,195.7 million. Therefore, Ofwat considers that the possibility of exceeding the statutory ceiling of 10% of the 2007-08 turnover figure is extremely remote. Section 22A does not set any minimum penalty.
163. Ofwat considers that the most appropriate approach to setting the level of the penalty in this case is by reference to the combined turnover of Severn Trent as the failings in this case prejudice the regulatory regime as a whole.

5.2 The level of the penalty

164. In considering the case for a penalty Ofwat is satisfied that Severn Trent has contravened a relevant Condition of its Appointment and that it is appropriate to propose to impose a financial penalty.

165. 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.
166. In arriving at the broad level of the penalty, Ofwat has given due weight to the fact that the contraventions arose from both deliberate misreporting of data and from the underlying failures and inadequacies of Severn Trent's internal systems and controls. These were not the actions of a company acting with due diligence.
167. Ofwat considers that Severn Trent's contraventions of Condition J and/or M are much more serious than Severn Trent's failures to achieve the standards of performance prescribed by the GSS Regulations, which are the subject of the GSS Notice. The contraventions of Condition J and/or M have a wider impact than the failures by Severn Trent to achieve the standards of performance prescribed by the GSS Regulations and have caused greater harm 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.
168. Misreporting of 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. The contraventions in this case have damaged the interests of Severn Trent's customers, and customers of the water and sewerage companies in England and Wales in general. Severn Trent's contraventions, if not appropriately penalised, would also lower confidence in the regulatory regime as a whole.
169. 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 Conditions J and M and to ensure that they have robust systems and processes in place, and deter companies from providing information that knowingly or otherwise misleads Ofwat.
170. Ofwat considers that the deterrent effect of the penalty on the industry is significantly greater than the quantum of the fine that is proposed in this case. The penalty on

Severn Trent will deter it from misreporting in future, but will also deter the industry more widely from misreporting information to Ofwat.

171. 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 of 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 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, in terms of its turnover, operating in the industry (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 more than 200% 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 contravention

172. As explained in section 2 of this Schedule, Severn Trent is required to furnish Ofwat with information on the quality of the service it provides to its customers in its June return under Conditions J and/or M of its Instrument of Appointment and that it is Ofwat's position that this information must be reliable, accurate and complete (within the bounds specified).

173. The specific contravention in this case is deliberate misreporting of performance against some of the DG Indicators (DG6, DG7 and DG9) and the misreporting of performance against some of the aspects of other DG indicators (DG3, DG6 and DG7) and compliance with GSS Regulations by Severn Trent when the 2005 June return was submitted, which included information relating to 2004-05, 2003-04, 2002-03 and 1997-98.
174. For the avoidance of doubt, in this section Ofwat considers the seriousness of that contravention in itself and on its own merits. Ofwat has not considered or taken account of the effect of any contravention occurring outside the period for which a penalty can be applied.
175. As set out in section 3, Severn Trent deliberately manipulated and misreported customer service data relating to account queries, written complaints and telephone call handling with the intent to deceive Ofwat as to its true performance and misreported other DG indicator information, GSS data and confidence grades. In addition to this, Severn Trent neglected its obligations in respect of the provision of information and failed to establish systems and processes to ensure that levels of service information in the 2005 June return was robust and that appropriate confidence grades were assigned.
176. As noted in section 4, the failure to furnish Ofwat with reliable, accurate and complete information within the bounds specified prejudices Ofwat's ability to fulfil its statutory duties and protect consumers. Severn Trent deliberately misreported information on its performance under some of the DG indicators and misreported information in relation to other DG indicator data and data relating to the GSS Regulations. Severn Trent's Board did not have an accurate picture of the service that Severn Trent was providing at the time and therefore did not recognise the need to take action. As a consequence Ofwat had a false picture of the service that Severn Trent was providing to its customers and could not therefore consider whether, and to what extent, corrective action was required, either through enforcement or through the setting of service standards.
177. Ofwat makes use of comparisons in fulfilling its statutory duties. Ofwat's ability to use comparisons to drive improvements, for example in service and efficiency, depends on the reliability, accuracy and completeness of the information which

undertakers furnish. There is an asymmetry between the level of information available to undertakers and to Ofwat. Ofwat operates arm's length regulation and relies on the information provided to it by undertakers. This is reflected in each company's Conditions of Appointment. The responsibility for collecting and providing reliable, accurate and complete regulatory information rests with the undertaker.

178. Severn Trent's misreporting, both deliberate and that as a result of weaknesses in systems and processes, has limited Ofwat's ability to take specific action to require Severn Trent to improve its service standards. As a result, water customers' confidence in Ofwat's ability effectively to regulate the water industry may have been damaged.
179. The regulatory regime makes considerable use of published performance data and comparisons between undertakers to deliver improved efficiency and service for customers. The DG indicator data is widely published and referred to by undertakers, CCWater and other interested parties.
180. Companies themselves regularly report this information in their published annual reports. In its 2004-05 annual report Severn Trent stated that "We successfully met all of our customer targets last year, an excellent result founded on the hard work of all our people. This means our customers continue to receive the high standards of service they deserve". The Managing Director's overview states "We have exceeded the AMP3 customer service targets".
181. The provision of inaccurate or unreliable information, particularly where misreporting has been undertaken deliberately, prejudices the regulatory regime. It undermines the confidence of undertakers and consumers in the data which is published and on which comparisons and regulatory decisions are based. It also prevents consumers from holding undertakers to account.
182. With regard to the duration of the contravention, Ofwat notes that the investigations by Severn Trent and E&Y found evidence of deliberate misreporting extending back to 1995 for DG6, 2001 for DG7, and 2002 for DG9. Statutory restrictions mean that Ofwat can only impose a penalty in respect of the period beginning 8 June 2005. However, the evidence of deliberate misreporting in prior years demonstrates that the contravention which occurred when Severn Trent submitted its June return on 10

June 2005 was not an isolated incident, and nor was it in any way unusual, unexplained, or 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

Damage to customers of Severn Trent

183. It is Ofwat's view that customers of Severn Trent suffered nuisance or harm to the extent that customers were receiving a service that was far below what the company was reported to be delivering and, in many cases, was below the statutory minimum standards prescribed under the GSS Regulations. By misreporting its performance, Severn Trent concealed the extent of its poor performance and failures to meet minimum standards, and prevented Severn Trent's Board and Ofwat from taking corrective action much earlier.
184. As discussed in section 4, Severn Trent benefited financially from a positive adjustment to its price limits through the OPA mechanism at the 2004 price review. That adjustment was partly based on misreported data and would not have been awarded had Severn Trent reported its performance accurately. As a consequence, Severn Trent's customers paid higher prices than they should have done. Severn Trent's misreporting in the 2005 June return led to customers continuing to pay higher prices than they should have in 2005-06, 2006-07 and 2007-08. Ofwat acknowledges that Severn Trent will refund the money gained in this way through a reduction in bills in 2008-09 and 2009-10.
185. Customers of water and sewerage undertakers in England and Wales and, particularly Severn Trent's customers, have suffered a loss of confidence in the information and service they receive. The fact that misrecording and misreporting has occurred in relation to the key levels of service information and the basic statutory standards of service set for individual customers is of direct concern to customers.
186. Ofwat publishes the data it collects on levels of service and undertakers' compliance with the GSS Regulations and the confidence grades associated with that data. Ofwat, CCWater and individual customers use that data to hold the undertakers to

account. If the real level of performance of an undertaker is misreported, as in this case, that is not possible. Customers' trust in undertakers to take seriously their levels of service commitments has been damaged.

187. In some cases, Severn Trent deliberately adopted practices that led to customers receiving standards of service below the level expected and below the levels provided by the industry as a whole. These failures were concealed from both Ofwat and the public by Severn Trent's contraventions of Conditions J and/or M.

Damage to other market participants

188. Because of the nature of the water industry, its role in public health and its high media profile, any failures by an undertaker can have a significant impact on the reputations of other water and sewerage undertakers. In this event, customers may have less confidence and trust in the industry as a whole, and their own undertaker in particular. The industry and the regulatory regime have suffered reputational damage because of the misreporting of data and other issues identified at Severn Trent and elsewhere.
189. Other water and sewerage undertakers have incurred additional costs arising from the additional quality assurance checks on undertakers' compliance with the GSS Regulations required by Ofwat in MD220. These costs cannot be directly attributed to Severn Trent alone, but it is the misreporting identified at Severn Trent and elsewhere (in respect of which Ofwat has taken and is proposing to take separate action) that has led Ofwat (and others) to question the trust that they can place in any of the information on customer service performance that is furnished to Ofwat across the water and sewerage industry.
190. Misreporting of regulatory information is always a serious issue which damages Ofwat's ability to regulate and ensure that customers' interests are protected. Misreporting as a result of deliberate action is significantly more serious than misreporting as a result of failures in processes and systems.

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

191. The OPA is a comparative tool used to incentivise improvement based on relative performance against a wide variety of measures, including customer service. Undertakers performing well relative to the industry can be awarded up to 0.5% extra on price limits at each five-yearly price review, whilst those performing less well can have a deduction of up to 1% applied to their price limits.
192. At the 2004 price review Severn Trent was awarded an upward adjustment of 0.1% through the OPA. However, if Severn Trent had reported its performance accurately, no upwards adjustment would have been applied to its price limits. This means that Severn Trent directly benefited to the detriment of its customers by misreporting its customer service performance deliberately and as a result of weaknesses in systems and processes. The positive 0.1% adjustment amounts to an extra £5m collected from customers over 5 years. Due to the timing of the discovery of the misreporting, Severn Trent benefited in its 2005-06, 2006-07 and 2007-08 price limits. Future price limits will be adjusted to ensure that Severn Trent does not continue to benefit in this way.
193. The adjustment made at the 2004 price review reflected performance reported by companies in 2002-03 and 2003-04. Information that was overstated was reported by Severn Trent in its 2003 and 2004 June returns. It was also included again in the 2005 June return. As a result of its contravention of Conditions J and/or M, in its 2005 June return, Severn Trent continued to represent to Ofwat, and to the public, a level of customer service performance for 2002-03 and 2003-04 that was substantially better than was actually the case. Because of this, Severn Trent continued to benefit from the OPA adjustment made at the 2004 review. If the contravention had not been discovered Severn Trent would have continued to overcharge its customers. Had corrected information been provided in the 2005 June return, Ofwat would have been able to take action to recalculate the OPA, as has now been done, at an earlier stage.
194. Ofwat recognises, however, that Severn Trent will return the financial benefit it gained through the OPA mechanism to customers through price adjustments in order to fulfil part of the undertaking it gave to Ofwat.

195. In addition to the direct benefit Severn Trent gained through the OPA, it also gained financially in that it deferred costs associated with establishing appropriately robust systems to compile and report regulatory data to Ofwat under Condition J and/or M. In its Section 203 Response, Severn Trent identified £1.6 million of annual expenditure it had already incurred to improve its performance against the DG Indicators (particularly DG6, DG7 and DG9), and a further £450,000 of additional expenditure it was likely to incur for further improvements. Severn Trent also noted that the costs of necessary upgrades to IT systems had not yet been evaluated.
196. Severn Trent has also avoided the costs of any action Ofwat might have taken at an earlier stage had its true performance been reported. Severn Trent also estimates in the Section 203 Response that the costs of the internal investigations and the E&Y Investigation are likely to exceed £500,000. Whilst not directly analogous to avoided costs, these figures give some indication of the scale of work which has now been necessary to establish the extent of the problem and identify the actions Severn Trent must carry out in order to address the deficiencies in its systems.

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

197. 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".
198. 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.

199. The cases which have informed Ofwat's proposal in this Notice are discussed in more detail below.
200. In considering the relative seriousness of Severn Trent's contravention of Condition J and/or M, Ofwat has had regard to 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 of its Conditions of Appointment. The contraventions in each case are different and are not directly comparable. In the United Utilities case the infringements concerned a breach of Condition F of its Conditions of Appointment which places a prohibition on companies cross-subsidising their associate companies.
201. Ofwat considers that the facts of the Severn Trent case mean that it has much more serious implications than the issues covered in the penalty notice for United Utilities. In the case of United Utilities Ofwat was aware of the breach and was able to take pre-emptive action to ensure that customers were protected and did not pay bills that were inflated by cross-subsidy. Ofwat was also able to take action to minimise any prejudice to its ability to make comparisons between companies. By contrast, in the case of Severn Trent the misreporting, both deliberate and that as a result of weaknesses in systems and processes, has prejudiced Ofwat's ability to make comparisons. In addition, until the misreporting came to light, Ofwat was not able to take action to require Severn Trent to improve its systems and the service it offered to its customers. This damaged the interests of Severn Trent's customers. Finally, the harm done to the regulatory regime as a whole cannot be corrected retrospectively. These features distinguish the Severn Trent case from the United Utilities case.
202. Ofwat is also mindful of the penalty it has imposed on Southern Water Services Limited ("Southern Water") in respect of the contravention of Conditions J and/or M of its Conditions of Appointment, as contained in a Notice published on 8 February 2008. Severn Trent's and Southern Water's cases both concern deliberate misreporting of regulatory information. Ofwat has considered the penalty it has

imposed on Southern Water in considering the appropriate penalty to impose on Severn Trent. Ofwat has also taken into account its proposal to impose a penalty on Thames Water Utilities Limited (“Thames Water”) in respect of Thames Water’s contraventions of Conditions J and/or M of its Conditions of Appointment, as contained in a Notice published on 9 January 2008.

203. Ofwat considers that this case and the Southern Water case are significantly more serious than the Thames Water case, for the following reasons:

- (i) Both Southern Water and Severn Trent deliberately misreported data in their June returns and this was not detected by internal controls or other processes. Thames Water’s misreporting also stemmed from systemic weaknesses in processes and controls but was not deliberate.
- (ii) Southern Water and Severn Trent deliberately attempted to report performance at a higher level than was actually the case;
- (iii) Southern Water and Severn Trent furnished incorrect data on GSS events, GSS payments and the DG Indicators, while Thames Water furnished incorrect data on GSS events, GSS payments and unreliable data on the DG Indicators; and
- (iv) Customers of Southern Water and Severn Trent were directly financially disadvantaged as both companies received positive OPA adjustments to which they were not entitled as a result of misreporting data.

204. Ofwat also considers that Severn Trent’s contraventions of Condition J and/or Condition M are also less extensive than those found at Southern Water:

- (i) Deliberate misreporting at Southern Water was more extensive than at Severn Trent, covering a wider range of DG Indicators;
- (ii) Misreporting at Southern Water was endemic within the Customer Services Department; and
- (iii) Southern Water gained a proportionally larger OPA adjustment than Severn Trent.

205. The level of penalty proposed in this Notice is therefore proportionately significantly higher than that proposed for Thames Water, but proportionately lower than that imposed on Southern Water.

206. Ofwat has had regard to precedents from other regulators in its consideration of the penalty proposed in this Notice but each is of limited value.
207. In March 2006 the Office of Rail Regulation (ORR) fined Network Rail £250,000 under section 57A of the Railways Act 1993 for failures to provide accurate information in respect of the capability of its infrastructure. A copy of the decision is available at www.rail-reg.gov.uk. This was a failure by a monopoly supplier to ensure that the information it makes available to the industry on the capability of its infrastructure was correct. This reflects the importance attached to accurate reporting of data by other regulators. However, the information was required for quite different purposes from the information required from Severn Trent in this case. The information required from Network Rail was important to participants in downstream markets.
208. Ofwat considers the seriousness of Severn Trent's contravention to be of a wholly different order of magnitude, since misreporting (and particularly deliberate misreporting) fundamentally prejudices the regulatory regime that Ofwat operates, which is based on comparative competition. In addition, the information misreported by Severn Trent affected individual consumers to their detriment, since Ofwat was unable to monitor the levels of customer service they received, in circumstances where those consumers do not have a choice of supplier for what is an essential service.
209. Ofwat has considered the decision of Ofgem in relation to two electricity distribution licensees, Yorkshire Electricity Distribution Limited ("YEDL") and Northern Electricity Distribution Limited ("NEDL"), taken under section 11 of the Electricity Act 1989 in June 2007. A copy of the decision is available at www.ofgem.gov.uk. Ofgem decided not to impose a penalty on YEDL/NEDL under section 27A of the Electricity Act 1989, which is directly equivalent to Ofwat's powers under section 22A WIA91. Nonetheless, Ofgem sought to correct the full financial impact of the misreporting on customers and additionally to impose a sanction on YEDL/NEDL for their failures to comply with their reporting obligations in relation to customer service performance by varying the conditions of their licences. As set out by Ofgem in its "Statement by the Gas and Electricity Markets Authority of Yorkshire Electricity Distribution plc and Northern Electric Distribution Limited's non-compliance with Standards Condition 49

of their Electricity Distribution Licences" of 6 June 2007, its decision did not mean that it would not impose financial penalties in future cases involving misreporting; and that its decision in this case reflected 'its specific circumstances'.

210. Having had regard to the Ofgem approach Ofwat does not consider that it is appropriate in the circumstances of Severn Trent's misreporting of information. Misreporting in the water and sewerage industry fundamentally prejudices the regulatory regime that Ofwat operates, which is based on comparative competition. Ofwat considers that a penalty is appropriate in these circumstances as it reflects the damage to all customers resulting from the prejudice to its ability to make comparisons. A sanction that only benefits the customers of Severn Trent would not achieve this.
211. A financial penalty is punitive in its nature and marks the seriousness with which Ofwat regards misreporting, and particularly deliberate misreporting, of information. Not only does it make clear to the company concerned the gravity with which Ofwat regards a contravention of this type, but it also signals the seriousness of the contravention more widely. Ofwat considers that a financial penalty in this case meets the primary purpose of the financial penalty system under section 22A WIA91, namely to give companies an incentive to comply with statutory and regulatory requirements now and in the future.
212. Ofwat considered Postcomm's approach to setting penalties to be corroborative of its own. In both its December 2003 and June 2006 decisions, Postcomm commented on the need for an appropriate disincentive to non-compliance. In the June 2006 decision, in particular, it concluded that the penalty figure arrived at was proportionate, stating that it had "considered the minimum amount that might make Royal Mail address the issues seriously on a continuing basis in the future". Ofwat is equally concerned to achieve deterrence at a proportionate level. The level that is proportionate depends heavily on the circumstances of each case.
213. The penalties imposed in other markets were of little assistance to Ofwat in reaching its decisions. Each was governed by different legislation and turned on its own facts.
214. The majority of customers in the water industry are entirely dependent on a monopoly supplier for an essential service and have no option to switch to another

provider. As such they are uniquely vulnerable. This absence of a competitive market is an important part of the context in which Ofwat has to consider what level of penalty will incentivise compliance and deter non-compliance in the industries it regulates.

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

215. No other penalty has been imposed or is proposed in relation to Severn Trent's contravention of Conditions J and/or M of its Conditions of Appointment. Ofwat has issued a notice under s22A(5) WIA91 in relation to failures by Severn Trent to achieve the standards of performance prescribed under the GSS Regulations on the same date as the date of this Notice.

5.3 The broad level of the penalty

216. 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, the broad level of the penalty, of 3.3% of turnover.

217. 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

218. Ofwat has considered the nature of Severn Trent's misreporting (i.e. that which was deliberate and that which was a result of weaknesses in systems and processes) in arriving at the broad level of the penalty. Ofwat acknowledges that it could have considered the nature of the misreporting as an aggravating factor. However, in this case, the nature of Severn Trent's misreporting, both deliberate and that as a result of weaknesses in systems and processes, was most appropriately dealt with in determination of the broad level of the penalty. It is Ofwat's view that the intentional nature of the misreporting in this case is key to assessing the seriousness of the contravention and in determining the appropriate broad level of the penalty. Ofwat has not therefore considered the nature of the misreporting as an aggravating factor.

219. Ofwat considers that the following factors aggravate the seriousness of Severn Trent's contravention of its Conditions of Appointment.

Making no attempt to rectify contraventions or failures after becoming aware of them

220. As set out in section 3.4 above, both the Severn Trent and the E&Y investigation identified instances where employees expressed concerns about being instructed to manipulate data and about internal systems and processes. Concerns were raised with the Senior Management Team within the Customer Relations Department but no further action was taken. Despite these concerns being raised by individual employees, Severn Trent took no action to stop the processes, which led to Severn Trent contravening its obligations to report reliable, accurate and complete data under Licence Conditions J and/or M.
221. The Customer Relations Department was also fully aware of the "Telephone Cross" procedure, by which letters of complaint about the quality of telephone contacts were not classified in the DG7 (written complaints) measures (see section 3.4 above). However, when the Reporter was present during routine audits staff were instructed to classify any complaint about ease of telephone contact as falling under DG7. This indicates that senior staff were fully aware of the failings but did not take the appropriate action, other than when inappropriate practices might be identified by third parties i.e. the Reporter.

Involvement of senior management in any contravention or failure

222. E&Y's investigation found that practices which resulted in the misreporting were repeatedly discussed by and documented in papers circulated to senior managers within the Customer Relations Department.

Inability to compensate those affected

- 223. Severn Trent is unable to compensate its own customers or customers across England and Wales, for the loss of confidence in the regulatory regime or the impact on Ofwat's work to protect consumers and drive service improvements.
- 224. Other water and sewerage undertakers will not be compensated for the additional costs or reputational damage they have suffered.
- 225. Having regard to each of the relevant aggravating factors, an increment equivalent to 0.1% of turnover is proposed.

5.5 Mitigating factors

- 226. Ofwat considers that the following factors mitigate the seriousness of Severn Trent's contraventions of Conditions J and/or M:

Appropriate action to remedy the contravention or failure

- 227. 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.
- 228. 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 proposing to impose a penalty in this Notice and Severn Trent is undertaking necessary steps to fulfil these obligations.
- 229. In December 2006 Severn Trent established an action plan to address the weaknesses found. This plan has been further developed to deal with additional issues, and progress against the plan is being reported to Ofwat.

230. In response to Ofwat's findings from its first investigation into allegations made against Severn Trent by an employee, Severn Trent has put in place a programme to address the cultural and behavioural issues Ofwat identified. Severn Trent has also carried a review of its processes and controls around the provision of regulatory information in the June return. Severn Trent reports quarterly to Ofwat on its progress with both these initiatives. During its investigation E&Y observed that Severn Trent "is committed to cultural change but recognises that a change programme such as this will take a significant period of time to become embedded."
231. Severn Trent also engaged E&Y to review the reliability of its high-risk data in its 2007 June return.

The extent to which the undertaker has compensated those affected

232. Severn Trent has, where individual customers could be traced, made GSS payments to those customers affected by failures against GSS Regulation 5. A small number of payments have been made to customers affected by failures against GSS Regulation 4. Severn Trent has also agreed to refund the benefit it gained through the OPA at the 2004 price review, together with a contribution reflecting the value of the GSS payments it could not make directly, via a reduction in prices in 2008-09 and 2009-10.

Proactive reporting of the contravention or failure to the enforcement authority

233. Severn Trent voluntarily reported the results of its internal investigation to Ofwat.

Cooperation with any investigation

234. Severn Trent cooperated with the E&Y Investigation, but the level of co-operation was no more than Ofwat would expect of any undertaker.
235. Having regard to each of the relevant mitigating factors, a deduction equivalent to 0.5% of turnover is proposed.

5.6 The penalty which Ofwat is proposing to impose

236. In its consideration of the amount of the penalty proposed to be imposed, Ofwat has attached particular weight to the seriousness of the contravention. Ofwat considers that deliberate misreporting of information to the regulator is amongst the most serious of breaches of an undertaker's duties, as it prejudices the comparative competition regime and compromises Ofwat's ability to regulate the water industry. This in turn causes harm to customers and other undertakers alike.
237. In this instance, the misreporting directly damaged customers' interests by allowing Severn Trent to continue charging higher prices than it should, and to continue providing a sub-standard service to customers whilst presenting itself as a high performing company. However, Ofwat acknowledges that Severn Trent has taken steps subsequently to offset any financial gain resulting from its misreporting, and the harm to customers and benefit to Severn Trent are therefore subsidiary factors in determining the quantum of the penalty.
238. Ofwat has taken due account of the mitigating factors in this case, including Severn Trent's reporting of the contravention and its co-operation with the investigation. Severn Trent has also taken steps to compensate its customers and to rectify the systemic failings and non-compliant practices which led to the misreporting. These outweigh the aggravating factors, and lead to a net reduction in the overall proposed penalty.
239. 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 penalty as measured by reference to its turnover. In setting a penalty for a smaller company, Ofwat would take account of that company's ability to pay the fine as measured by reference to its turnover. 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.

240. Ofwat's consideration of the appropriate amount of a penalty has also been guided by the penalty proposed for Thames Water and the penalty imposed on Southern Water for their contraventions of Condition J and/or Condition M. Ofwat considers that, in terms of the nature and extent of the contraventions, Severn Trent's case is much more similar to Southern Water's than to Thames Water's. Consequently, the penalty proposed in this Notice is assessed more by reference to that imposed on Southern Water than that proposed for Thames Water.
241. Having regard to the balance of mitigation and aggravation and all other relevant factors, Ofwat therefore considers it appropriate to propose to impose a penalty of 2.9% of Severn Trent's applicable turnover, for the 2006-07 business year. This amounts to £34.7 million.

6. How to make representations or objections

242. Pursuant to section 22A(4) 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.
243. 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 – Conditions of Appointment".

244. 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

Condition J: Levels of Service Information and Service Targets

Part I. *Levels of Service Information*

1. *Provision of Information*

1.1 The Appointee shall in respect of each Charging Year, starting with the Charging Year commencing on 1st April 1990, furnish Information to the Director once in each Charging Year in respect of the matters specified in, and otherwise in accordance with, Appendix A to the letter entitled "Levels of Service" dated 21st August 1989 from the Secretary of State to the Water Authority ("**the Levels of Service Letter**").

1.2 Where the Director is satisfied that the provision of Information in respect of the matters specified in Appendix A to the Levels of Service Letter is inadequate to enable him properly to keep the quality of the services provided by the Appointee in the course of the Appointed Business ("**Services**") under review the Director may, subject to prior consultation with the Appointee, by notice to the Appointee vary the matters specified in that Appendix in respect of which Information is to be furnished under sub-paragraph 1.1 in a manner which is reasonable having regard to the Director's duties under sub-sections (1) and (2) of section 26 [section 27 of the 1991 Act] and thereafter the Appointee shall in respect of each Charging Year furnish Information to the Director in respect of those matters as so varied. The Director may, subject as aforesaid, make variations from time to time under this sub-paragraph and references in this sub-paragraph to the matters specified in Appendix A to the Levels of Service Letter shall be read and construed as though they were references to the matters specified in Appendix A as varied from time to time.

1.3 Where the Director considers it requisite or expedient for the purpose of deciding whether to make an application to the Secretary of State under section 38 [section 38 & 39 of the 1991 Act] or 68 [section 95 & 96 of the 1991 Act] (and, if so, what provisions should be set out in the application) or to require the Appointee to notify a Service Target under sub-paragraph 3.2 the Appointee shall furnish to the Director:

(1) such further Information as the Director reasonably requires in respect of the

quality of Services; and

- (2) Information in respect of the quality of Services in respect of any reasonable period other than a Charging Year and/or more frequently than once in a Charging Year (but not more frequently than is reasonable) as may be specified by the Director. Such Information, at the Appointee's option, may consist of updating Information previously furnished to the Director under sub-paragraph 1.1, 1.2 or 1.3(1).

1.4 In this Condition references to the quality of Services shall include references to the manner in which the Appointee carries out the Regulated Activities.

2. *Reports, Certificates etc*

Information furnished to the Director by the Appointee under paragraph 1 (other than under sub-paragraph 1.3) and, where the Director so requires, Information furnished to him by the Appointee under that sub-paragraph, ("**Levels of Service Information**") shall be accompanied by:

- (1) a report, signed by or on behalf of the Appointee, containing such information as the Director may reasonably specify as to the methods used, and the steps taken, by the Appointee for the purpose of monitoring, assessing and reporting on the matters in respect of which Levels of Service Information has been furnished; and
- (2) a statement, signed by or on behalf of the Appointee, of the reasons why, and the extent to which, (if such be the case) the quality of any Services shall have been such that any standard by reference to which Levels of Service Information has been furnished shall not have been met. The Statement shall include, without limitation, information as to the categories of persons to whom those Services have been so provided or who have been affected by the carrying on of the Appointed Business in that manner and their geographical distribution.

Part II. *Service Targets*

3. *Setting of Service Targets by the Appointee*

- 3.1 The Appointee shall once in each Charging Year, starting with the Charging Year commencing on 1st April 1990, notify the Director of its intentions as to the quality of such Services as are specified in Appendix B to the Levels of Service Letter in respect of each Charging Year falling within the period beginning at the start of the Charging Year in which the notification falls to be given and ending on the expiry of such number of Charging Years as is specified in that Appendix and otherwise in accordance with the procedures specified in that Appendix.
- 3.2 Where the Director considers it requisite or expedient for the purpose of enabling him properly to keep the quality of Services under review the Director may require the Appointee to notify him of its intentions as to the quality of such other Services in accordance with such requirements as the Director may reasonably specify.
- 3.3 The Appointee's intentions shall be expressed in any notification under sub-paragraph 3.1 or 3.2 as a target (a "**Service Target**") for achievement by such date or over such period or at such times during such period as may be specified in Appendix B to the Levels of Service Letter or, as the case may be, as the Director may have specified when he requires the Appointee to notify him of its intentions under sub-paragraph 3.2 and in respect of the whole or such part of the Area as may be specified in the said Appendix B or, as the case may be, as the Director may have so specified and so as to be capable of verification in accordance with this Condition.

4. *Monitoring of Service Targets*

The Appointee shall keep under review during each Charging Year the quality of Services as compared with any relevant Service Target notified by it to the Director under paragraph 3 as a target for achievement during that Charging Year or by a date or at a time during that Charging Year or over a period including that Charging Year. For this purpose the Appointee shall take such steps to monitor and assess the quality of Services as may be necessary to enable such comparison to be made and to enable the Appointee to make the report referred to in paragraph 5.

5. *Reporting on Service Targets*

5.1 The Appointee shall furnish to the Director a written report (a "**Service Target Report**") as to the quality of Services as compared with any relevant Service Target.

5.2 A Service Target Report shall include:

- (1) all such Information as in the opinion of the Appointee is necessary to provide a proper explanation of the Report and of the quality of Services as compared with any relevant Service Target;
- (2) a statement of the methods used by the Appointee to keep the quality of Services under review in accordance with paragraph 4 and the steps taken by it to monitor and assess the quality of Services in accordance with that paragraph; and
- (3) if a Service Target in respect of foul flooding has been notified by the Appointee to the Director relating to the Charging Year in respect of which the relevant Service Target Report is furnished, a statement as to the Appointee's practice in dealing with claims arising out of loss or damage alleged to have been caused by foul flooding.

5.3 Without prejudice to the generality of sub-paragraph 5.2, a Service Target Report may include a statement of:

- (1) any matters which, in the opinion of the Appointee, will or may result in the Appointee being unable to achieve any Service Target or which have resulted in the Appointee being unable to achieve any Service Target to the extent that it was expressed in the notification to the Director under paragraph 4 to be a target for achievement during the relevant Charging Year or by a date or at a time during that Charging Year;
- (2) any matters which have made it impossible for the Appointee to ascertain, either at all or with reasonable accuracy, whether or not any Service Target has been, or is likely to be, achieved; and
- (3) any exceptional matters or matters out of the ordinary course and in each case outside the reasonable control of the Appointee which have affected the

quality of any Services and which could fairly be said to render or to have rendered the achievement of any Service Target substantially more onerous.

5.4 The Appointee may also specify in a Service Target Report any revision of any Service Target which the Appointee has determined to make having regard to any matters included in that Service Target Report, including, without limitation, such matters as are referred to in sub-paragraph 5.3. Such revision may be, without limitation, as to the date by, or the period over, or the times at, which during any period the relevant Service Target was intended to be achieved, or the part of the Area in respect of which the relevant Service Target was intended to be achieved. Any such revised Service Target is hereinafter referred to as a "**Revised Service Target**". Paragraphs 4, 5 (including this sub-paragraph) and 6 to 13 inclusive shall apply mutatis mutandis to any Revised Service Target.

5.5 The Appointee shall once in each Charging Year furnish a Service Target Report to the Director in respect of that Charging Year, provided that, if the Director considers it requisite or expedient for the purpose of deciding whether to make an application to the Secretary of State under section 38 [section 38 & 39 of the 1991 Act] or 68 [section 95 & 96 of the 1991 Act] (and, if so, what provisions should be set out in the application) the Appointee shall furnish a Service Target Report more frequently (but not more frequently than is reasonable).

6. *Measures to achieve Service Targets*

Where, following receipt by the Director of any Service Target Report, he considers it requisite or expedient for the purpose of deciding whether to make an application to the Secretary of State under section 38 [section 38 & 39 of the 1991 Act] or 68 [section 95 & 96 of the 1991 Act] (and, if so, what provisions should be set out in the application), the Appointee shall furnish to the Director in writing within such reasonable period as the Director may specify such further Information as the Director may reasonably require, including, but not limited to, Information as to:

- (1) the respective measures required to be taken to achieve any Service Target and the respective costs of such measures (and, where more than one measure is available, whether or not subject to the expenditure of money, the Appointee shall give details of the alternative measures); and

- (2) the measures being taken or proposed to be taken to achieve any Service Target.

Part III. *Certification and Verification of Information*

7. Levels of Service Information and Service Target Reports required to be furnished once in each Charging Year shall be accompanied by a certificate, signed by the Auditors (or by such other person as the Director may approve, such approval not to be unreasonably withheld) stating whether, in their opinion, the relevant Levels of Service Information and Information contained in the relevant Service Target Report has been ascertained by the use of the methods and the taking of the steps which the Appointee has informed the Director it has used and taken and whether, in their opinion, the methods used and the steps taken are adequate for the purpose of ascertaining that Levels of Service Information and the Information contained in that Service Target Report. To the extent that Levels of Service Information and a Service Target Report contain the same Information and are furnished at the same time only one certificate need be provided under this paragraph. Levels of Service Information and Service Target Reports furnished in accordance with any requirement of the Director under sub-paragraph 1.3 or sub-paragraph 5.5 shall also be accompanied by a like certificate if the Director so requires.
8. The Appointee shall co-operate fully with the Director in any investigation of:
 - (1) the accuracy and sufficiency of any Information furnished by the Appointee to the Director under this Condition;
 - (2) the methods used and steps taken by the Appointee to ascertain any such Information; and
 - (3) whether any Service Target has been achieved

which the Director may carry out for the purpose of deciding whether to make an application to the Secretary of State under section 38 [section 38 & 39 of the 1991 Act] or 68 [section 95 & 96 of the 1991 Act].

9. Such co-operation shall include, without limitation:
- (1) subject to reasonable prior notice to the Appointee, giving to the Director access at reasonable hours to any Relevant Plant and to any premises occupied by the Appointee in relation to carrying out the Regulated Activities; and
 - (2) subject to reasonable prior notice to the Appointee, allowing the Director at reasonable hours:
 - (a) to inspect and make photocopies of, and take extracts from, any books and records of the Appointee maintained in relation to the Appointed Business;
 - (b) to carry out inspections, measurements and tests on or in relation to any such premises or Relevant Plant; and
 - (c) to take on to or in to any such premises or Relevant Plant such other persons and such equipment as may be necessary for the purpose of such investigation.
10. Nothing in paragraphs 8 and 9 shall require the Appointee:
- (1) to do anything which is outside its reasonable control; or
 - (2) to do, or to allow the Director to do, anything which would materially disrupt the Appointee's business (unless it is essential for the purposes of the investigation that that thing be done).
11. The Appointee shall not be liable to the Director for any loss or damage to persons or property which arises out of the Director having such access or doing any such thing as is mentioned in paragraphs 8 and 9 except to the extent that such loss or damage is caused by the Appointee's negligence or wilful default.
12. In paragraphs 9, 10 and 11:

- (1) references to the Director include references to his employees and agents:
and
- (2) "**Relevant Plant**" means any plant used by the Appointee for the purpose of the Appointed Business including, without limitation, water mains, sewers and other pipes and their accessories.

Part IV. *Publication of Information*

13. Unless the Director otherwise consents in writing (such consent not to be unreasonably withheld) pursuant to an application to him in that behalf by the Appointee when the relevant Information and Reports are furnished to the Director under this Condition the Appointee shall:
 - (1) draw the attention of customers to the existence of Levels of Service Information (excluding any report or statement furnished under paragraph 2) and Service Target Reports furnished to the Director under this Condition in respect of a Charging Year;
 - (2) make a copy of the most recent Levels of Service Information (excluding any report or statement furnished under paragraph 2) and Service Target Report available for inspection at each Relevant Premises; and
 - (3) send a copy of the most recent Levels of Service Information (excluding any report or statement furnished under paragraph 2) and Service Target Report to any person requesting it.

Condition M: Provision of Information to the Director

1. Subject to paragraphs 3, 4 and 5 the Appointee shall furnish the Director with such Information as the Director may reasonably require for the purpose of carrying out any of his functions under the Act.
2. Information required to be furnished under this Condition shall be furnished in such

form and manner and at such times and be accompanied or supplemented by such explanations as the Director may reasonably require.

3. This Condition shall not require the Appointee to furnish the Director with Information in respect of any function of the Director under sections 16 [section 14 of the 1991 Act], 26 [section 27 of the 1991 Act] and 34 [section 201 of the 1991 Act] but the Appointee shall, if requested by the Director, give reasoned comments on the accuracy and text of any information or advice which the Director proposes to publish pursuant to section 34 [section 201 of the 1991 Act] and, subject always to section 174 [section 206 of the 1991 Act], nothing in this paragraph shall prevent the Director from using or disclosing any Information with which he has been furnished under this Condition or any other Condition of these Appointments for the purpose of carrying out his functions under the Act (including, without prejudice to the generality, under sections 16 [section 14 of the 1991 Act], 26 [section 27 of the 1991 Act] and 34 [section 201 of the 1991 Act]).

4. Neither this Condition nor any other Condition of these Appointments shall require the Appointee to furnish any Information for any such purpose as is referred to in section 33 [section 203 of the 1991 Act] which it could not be compelled to produce or furnish under that section.

5. Neither this Condition nor any other Condition of these Appointments shall require the Appointee to furnish any Information which it would be entitled to refuse to disclose or produce on grounds of legal professional privilege in proceedings in the High Court.

6. Where, under any other Condition of these Appointments, the Appointee is or can be required to furnish Information to the Director there shall be a presumption that the furnishing of that Information in accordance with that Condition is sufficient for the relevant purposes of that Condition but this presumption shall be rebutted, and shall not limit the right of the Director to call for further Information under paragraph 1, if he states in writing that in his opinion such Information is or is likely to be necessary for the purpose of carrying out any of his functions under the Act.

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 services². 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 Ofwat³, 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 amount⁴. 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 1998⁵. 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 Act⁶. 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.

² Section 22A(1) and (2) of the Act.

³ 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.

⁴ Section 22B of the Act.

⁵ Section 22A(13) of the Act.

⁶ 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 Wales⁷.

- 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 Act⁸.

⁷ Section 22A(11) of the Act.

⁸ Section 22B(3) to (5) of the Act.